TAX REFORM AND DEFICIT REDUCTION

HEARINGS

BEFORE THE

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HOUSE OF REPRESENTATIVES
NINETY-EIGHTH CONGRESS
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TAX REFORM AND DEFICIT REDUCTION

TUESDAY, SEPTEMBER 25, 1984

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met at 9:45 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press releases announcing the hearings follow:]

[Press release No. 28, Monday, Sept. 10, 1984]

HON. DAN ROSTENKOWSKI (D. ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES HEARINGS ON TAX ALTERNATIVES

The Honorable Dan Rostenkowski (D. Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, announced today that the Committee will hold panel discussions on alternatives to restructure the Internal Revenue Code and reduce the deficit. The hearings will be held on September 25, 26, and 27, 1984, in Room 1100 Longworth House Office Building. Panel topics will include: (1) A market perspective; (2) Tax simplification; (3) Consumed income taxes; (4) Energy taxes; (5) Value-added taxes; and (6) National sales taxes.

The panels will be comprised of invited expert witnesses. The order of the panels, the times, the names of the witnesses and other details will be announced at a later date.

[Press release No. 29, Friday, Sept. 21, 1984]

HON. DAN ROSTENKOWSKI (D. ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES CHANGE IN SCHEDULE OF WITNESSES FOR HEARING ON TAX REFORM AND DEFICIT REDUCTION

The Honorable Dan Rostenkowski (D. Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, announced today a revised schedule for the hearings on tax reform and deficit reduction on September 25, 26, and 27, 1984. The names of those witnesses invited to testify before the Committee and the schedule for their appearance is as follows:

TUESDAY, SEPTEMBER 25—THE DEFICIT

9:30 a.m.—Rudolph Penner, Director, Congressional Budget Office.

10:30 a.m.— Henry Kaufman, Executive Director, Salomon Brothers, Inc. and Felix Rohatyn, Senior Partner, Lazard-Freres.

12:00 p.m.—Gary Wenglowski, Goldman, Sachs and Company.

1:30 p.m.—Pierre Rinfret, Rinfret Associates, Inc.

WEDNESDAY, SEPTEMBER 26—FUNDAMENTAL TAX RESTRUCTURING

10:00 a.m.—Paul McDaniel, Professor of Law, Boston College Law School; David Bradford, Professor of Economic and Public Affairs, Princeton University; Daniel I. Halperin, Professor of Law, Georgetown University Law Center; and Emil M. Sunley, Deloitte, Haskins and Sells (formerly Deputy Assistant Secretary of the Treasury for Tax Analysis).

11:30 a.m.—Harvey Galper, Senior Fellow, The Brookings Institution; Henry J. Aaron, Senior Fellow, The Brookings Institution; Robert Hall, Professor of Economics, Stanford University; Alvin Rabushka, Senior Fellow, Hoover Institute; and Richard Goode, Guest Scholar, The Brookings Institution.

THURSDAY, SEPTEMBER 27—CONSUMPTION TAXES

10:00 a.m.—C. Lowell Harriss, Professor Emeritus, Columbia University, Executive Director, Academy of Political Science; and Hugh Calkins, Vice Chairman, American Bar Association.

2:00 p.m.—Gerard M. Brannon, Director of Special Projects, American Council of Life Insurance (formerly Deputy Assistant Secretary of the Treasury for Tax Analysis); and Frank Zarb, Senior Partner, Lazard-Freres.

WRITTEN STATEMENTS FOR THE RECORD OF THE HEARING

Testimony will be received from invited witnesses only. All others interested in submitting written statements for the record of the hearing are encouraged to do so. However, written statements will be accepted only on the following subject areas at this time: (1) The deficit (interest rates, capital formation, foreign competition); (2) Fundamental tax restructuring; and (3) Consumption taxes.

Persons submitting written statements should submit six copies by the close of business on Friday, September 28, 1984, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C.

Chairman **Rostenkowski**. Good morning, ladies and gentlemen.

We open these hearings as the 98th Congress draws to a close. This committee has left behind a solid record, including the Social Security Amendments of 1983, the Tax Reform Act of 1984, and an omnibus trade bill that we hope to finish this afternoon. But we leave Washington with a nagging sense of foreboding, a sense that economic forces are gathering momentum, a sense that the next few years will demand more courage and more vision both from Congress and the White House.

It is this need for vision that leads us today to assess not only the present but to scan the horizon. We all agree that our tax system is in need of repair. Over the years, taxes have become not only a source of revenue but also a tool for social and economic change. As we prepare for next year, we ought to recognize that this will largely guide our hand. On the one hand, we must raise revenue to reduce the deficit. On the other, we must seek to simplify and reform the Tax Code as a whole.

The two tasks are not necessarily compatible or done at once. The central issue that I would like to pursue today is the deficit, whether an economy can recover and grow carrying incredible debt. It is a great puzzle to many of us here in an attempt to measure the rate of deficit growth and the options for its control. I am pleased to invite as our first witness today Dr. Rudolph Penner, Director of the Congressional Budget Office.

However, I yield first to Mr. Conable.

Mr. **Conable**. Thank you, Mr. Chairman.

I would like to make a somewhat broader statement realizing that these hearings are going to go on and invite a wide range of testimony. I think it is entirely appropriate as a matter of fact. I would like to commend you for calling these hearings and for assembling the distinguished list of witnesses from whom we will hear over the next few days.

There has been a great deal of frustration in the academic and business community about the growing complexity of our total system and the sense that we didn't have a clear idea of where we were headed. The issues which they will discuss are certainly ones which the Congress and in particular this committee will have to wrestle with in the coming Congress and probably beyond.

I am certain that various experts whom we will hear from will direct our attention to the important factors which should be considered in embarking on any far-reaching tax legislation in the future, there are several cautions that I think the committee should keep in mind.

First, tax legislation in the past couple of years, beginning with the Economic Recovery Tax Act of 1981, has imposed a tremendous learning burden on the public in general and in particular, practitioners who must advise taxpayers. In considering the advisability of any additional tax legislation in the near future, I think this is a factor which should be seriously taken into account. That is, the extent to which additional significant modifications of the tax laws can be absorbed by the public without resulting in massive compliance failures which are the result of an inability to assimilate new tax provisions.

Second, I think the committee should exercise caution about the extent to which it embarks on major restructuring proposals in the interest of simplification. While the repeal of various deductions and credits which are a part of our existing tax system will achieve some degree of simplification, we should not be misled into believing that such changes will create a system which is necessarily easily understandable and free of ambiguity. Some degree of complexity is an unavoidable characteristic of a tax system which applies to a complex economy such as ours if the system is to have some degree of equity.

As I have said before, it is equity which is one of the greatest enemies of simplicity. By way of example, I would point to many of these provisions of the recently enacted Tax Reform Act of 1984. Many of these provisions would not be affected by the various simplification proposals which have been introduced.

The various representations with respect to the simplification proposals on revenue neutrality also should be carefully examined. In fact, while these proposals are revenue neutral in the sense that they are designed to collect the same amount of taxes that are raised through the current system, they are not in fact budget neutral in the sense that the tax code is used currently as a means of achieving a significant amount of social spending through the various incentives which are provided in the code.

To the extent that a number of these provisions are repealed or made less efficient as a result of lower tax rates, the Congress will be faced with the inevitable decision of whether to continue this social spending through direct spending as compared to the way it is currently achieved. To the extent a decision is made to continue these programs through direct spending, it will be necessary to craft a system which actually raises more in tax dollars than one current system to simply maintain the current deficit level and the current level of service.

By raising these points, I do not mean to discourage the effort to review our system to determine what fundamental reform is appropriate. Certainly the role which the modification of our tax system is playing in the current Presidential election is an indication of the public interest in embarking on such a review.

Let me make one final observation about this decree of public interest in tax reform, however. In the past, the Congress has been able to enact tax reform which was far reaching principally by coupling it with some form of tax cut. As a result, when "Joe Public" looked at his bottom line, tax reform looked like a pretty good idea because it reduced his tax burden.

I suspect that he will have a distinctly different impresion if his tax burden remains the same, or much worse, if it goes up. At a minimum, that might be the result if total tax collection were increased to provide a fund of revenue to offset the concurrent decrease in social spending which would result from the repeal of various deductions, credits, and exclusions.

My only purpose in raising these points is to highlight some of the "pitfalls" which exist for those who would charge blindly forth in the name of simplification and tax reform. I am sure that the witnesses that have been assembled for the next couple of days of hearings will do far better than I in identifying the various important considerations. I certainly look forward to hearing from them and I want to repeat, Mr. Chairman, I think this is an entirely appropriate thing to be doing and the concern of this committee for some overview of the tax system is timely and your leadership is to be commended in pressing for this type of review.

Chairman ROSTENKOWSKI. I thank the gentleman.

Mr. Gephardt, do you have a statement?

Mr. GEPHARDT. Thank you, Mr. Chairman.

I would add my voice to Mr. Conable's in commending you for calling these hearings. I think that it is appropriate that these hearings start at an early point. It is obvious that action by the committee will not be taken until next year when we enter the budget debate, but it is clear that when we look at the deficits and the defict path we are looking at, it is not a question of whether we will raise taxes but how we will raise taxes and therefore I think it appropriate to begin this overview of the entire Tax Code and all the different proposals for reform that have been made.

I obviously have a bias, but I come to it with an open mind. It was a humbling experience for Senator Bradley and I to sit down with the Tax Code and to try to write an overall reform. I have many questions left in my mind about what we do because there are lots of hard questions that nobody has an answer to, but I am convinced of one thing. That is that I think that what started to be a pretty simple affair in 1913 has gotten out of hand and that we are on our way in the name of fairness to writing a separate Tax Code for everybody and every corporation in the country and I think that we would benefit from a tax policy viewpoint, from a fairness viewpoint and from an economic viewpoint if we could return to a simpler and fairer code.

I think the good of the whole would be enhanced even though parts of our economic community and parts of society would feel put upon by going back to a simpler and fairer code.

I have no illusions about the difficulty of this or about all the disagreement that will come, but I think that it is time for this to happen and I am convinced that this committee has the capacity to do everything that needs to be done to approach these questions and come up with answers.

Chairman **Rostenkowski**. Welcome, Dr. Penner.

Mr. **Penner**. Thank you very much, Mr. Chairman.

With your permission, I will give you a brief summary of the testimony.

Chairman **Rostenkowski**. Without objection, your entire statement will be included in the record.

STATEMENT OF RUDOLPH G. PENNER, DIRECTOR, CONGRESSONAL BUDGET OFFICE

Mr. **Penner**. It is my role to focus not on tax policy as much as on the economic and deficit outlook. The economic forecasts that we released in August suggest that through the end of 1985, the economic recovery will remain in good shape. We expect continued growth, though at a less rapid rate than in the first half of 1984. In our view, there is little chance of recession, and we expect unemployment to continue to decline gradually.

Inflation remains under control in CBO's forecast, though it accelerates slightly in 1985 because of our assumption that the dollar and oil prices, both of which contributed to lower inflation this year, will level off. Food prices are expected to rise a little faster next year than this. Interest rates are expected to decline next year because of our assumed slowdown in economic growth, but only by very marginal amounts.

There are, of course, risks to this optimistic story. So far our economy has benefited greatly from the capital that has been made available from international capital markets. If that should be cut off abruptly, we could have problems, but again we do not expect that to happen. After 1985, we do not purport to make an economic forecast. It is just too far away to do that. We simply rely on historical growth trends and assume that the growth record of the future will be comparable to that of the past.

Over that period, according to our forecast, unemployment will decline, but very slowly. The downward trend in inflation will cease after unemployment falls below 6.5 percent, and we somewhat arbitrarily assume that interest rates will just go flat.

With respect to the budget outlook that all of this implies, changes from our February economic forecasts and projections have had really little impact on the way we view the budget outlook. We are now assuming a little more economic growth than we did in February, but the effects on the budget are offset by our need to raise our interest rate assumptions. Legislation over the past year, however, has been important to the budget outlook. In our earlier projections, we had a deficit rising faster than the gross national product. That has been stabilized by the Deficit Reduction Act and other legislation. While before we were projecting a deficit at almost 6 percent of the GNP by 1989, now we have it at slightly less than 5 percent.

Unfortunately, however, the deficit has been stabilized at such a high level that the debt outstanding continues to grow very much more rapidly than our gross national product. That is very important in our view. Even if we have constant interest rates over time, as long as that debt is growing faster than GNP and faster than our revenues, the interest bill on that debt is itself a major budget problem. If we could just get deficits low enough so that the debt to GNP ratio were falling instead of rising, then what is now a very major part of the budget problem could become a major part of the budget solution.

Thank you very much, Mr. Chairman. I will take your questions.

[The prepared statement follows:]

STATEMENT OF RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to have the opportunity to testify on the economy and the federal budget. My testimony today will be based in part on the recently completed report by the Congressional Budget Office (CBO) on The Economic and Budget Outlook: An Update (August 1984), which you received earlier.

Despite continued high interest rates, record trade deficits, and signs that economic growth is slowing, most forecasters believe the near-term outlook for the economy remains quite good. In contrast, the budget deficit outlook continues to be worrisome, given policies now in place. Although CBO forecasts a decline in the deficit from $195 billion last year to $172 billion in the current fiscal year, our projections also show that under current policies, it would rise steadily to $263 billion in 1989. Deficits of this magnitude would lead to a rising federal debt relative to GNP, which woud put upward pressure on interest rates and imply rapidly escalating debt service costs.

RECENT ECONOMIC DEVELOPMENTS

Recent economic developments have generally been positive. For example, output growth accelerated in the first half of 1984 (Table 1), an unusual development in the second year of recovery. Rapid growth occurred despite a rise in interest rates. Real GNP rose at a 10 percent rate in the first quarter, but decelerated somewhat to a 7 percent rate in the second quarter. Business fixed investment expanded at more than a 20 percent rate, even though real interest rates (interest rates adjusted for inflation) were extraordinarily high. The only major source of weakness in both quarters was net exports, the result of imports rising very sharply in response to the strong growth in the domestic economy and to the very high exchange value of the dollar.

Resources were utilized more fully during the first half of the year. Payroll employment expanded by more than two million, while the unemployment rate fell by a full percentage point. Capacity utilization moved up to 82 percent in the second quarter of the decade, compared to 79 percent in the fourth quarter of last year.

Although economic growth accelerated, inflation continued to be well-behaved. The GNP deflator rose at a rate of 4 percent to 5 percent in the first half of the year, while the Consumer Price Index (CPI) rose at roughly the same rate. That is up slightly from the inflation rate in 1983, but not by much. Moreover, there was little evidence of any of the usual signs of inflationary pressures, such as escalating raw material prices or bottlenecks. In fact, fuel prices have been particularly weak. The continued strength of the dollar has undoubtedly contributed substantially to the low rate of inflation, both by keeping down the prices of imported goods and by exerting competitive pressures on domestically produced goods.

CBO's August forecast anticipated a slowdown in economic growth and recent signs indicate that this is occurring:

TABLE 1. RECENT ECONOMIC INDICATORS (Percent change from previous period at seasonally adjusted annual rates, unless otherwise noted)

	1981	1982	1983	1983				1984	
				I	II	III	IV	I	II
Real GNP	2.5	-2.1	3.7	3.3	9.4	6.8	5.9	10.1	7.1
Final sales	1.5	-0.7	3.2	1.1	6.4	4.9	4.2	3.6	10.3
Consumption	2.0	1.4	4.8	2.6	10.0	3.8	6.8	4.6	7.9
Business fixed investment	5.6	-4.7	2.5	0.0	9.6	18.7	30.6	20.6	21.3
Residential investment	-5.4	-15.0	41.7	64.5	78.1	31.6	4.0	21.3	1.2
Government purchases	1.0	2.0	-0.3	-8.2	-2.6	-.5	-4.3	1.0	18.6
Inventory Change (billions of 1972 dollars)	11.3	-10.4	-3.6	-16.5	-6.1	0.9	7.2	31.6	20.3
Net Exports (billions of 1972 dollars)	43.8	29.7	12.6	22.9	13.6	11.9	2.0	-8.3	-11.4
Industrial Production	2.7	-8.2	6.5	10.0	18.3	22.0	10.0	11.5	8.6
Capacity Utilization (percent)	80.2	72.1	75.3	71.2	73.9	77.3	78.8	80.6	81.6
Payroll Employment (millions)	91.2	89.6	90.1	88.8	89.6	90.4	91.7	92.8	93.8
Civilian Unemployment Rate (percent)	7.6	9.7	9.6	10.4	10.1	9.4	8.5	7.9	7.5
Inflation Rate									
CPI-U	10.4	6.1	3.2	0.3	4.4	4.1	4.5	5.0	3.7
GNP deflator (fixed weight)	9.7	6.4	4.2	3.3	4.1	4.7	3.9	5.0	4.3
Productivity a/	1.4	0.2	3.5	4.4	8.1	2.1	1.0	2.9	4.7
Interest Rates (percent)									
Treasury bill rate	14.0	10.6	8.6	8.1	8.4	9.1	8.8	9.2	9.8
Corporate AAA bond rate	14.2	13.8	12.0	11.8	11.6	12.3	12.4	12.3	13.2

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Moody's Investors' Service.

a/ Output per worker hour, nonfarm business sector.

- The Index of Leading Indicators has declined for two straight months;
- Housing starts have declined for two months in a row--by almost 7 percent in July and by another 13 percent in August;
- New orders for nondefense capital goods declined in June and again in July;
- Retail sales have declined for two consecutive months--by 2 percent in July and by almost 1 percent in August;
- Employment activity appears to have slowed in July and August, although the payroll series and the household survey differ about the extent of the slowing; and
- The Commerce Department's very preliminary "flash" estimate shows real GNP growth slowing to a 3.6 percent annual rate for the third quarter.

THE CBO ECONOMIC PROJECTIONS

The CBO economic projections consist of two parts: (1) the economic forecast for the remainder of 1984 and for 1985, which is contingent on specific assumptions about policy, certain critical raw material prices, and foreign exchange rates; and (2) longer-run projections through 1989, which are based on historical growth trends.

The Forecast for 1984 and 1985

The economic forecast is based on the following assumptions:

- Budget outlays are estimated at $845 billion this fiscal year and $929 billion in 1985, reflecting real growth in defense budget authority of 5 percent per year. Revenues are estimated at $673 and $751 billion in fiscal years 1984 and 1985, respectively.
- The growth rate in the monetary aggregates M1 and M2 is assumed to be 6.0 percent and 7.5 percent, respectively, during

the second half of this year. Next year, M1 and M2 are assumed to grow 5.5 percent and 7.25 percent, respectively, at the midpoints of the Federal Reserve's target ranges announced on July 25.

- The dollar exchange rate is assumed to remain at its average level of the past several months; the price of crude oil to remain near the current level; and food prices to rise about 4 percent this year and about 5 percent next year.

Based on these assumptions, the CBO forecast shows continued growth for the remainder of this year and next, but at a decelerating rate. The rapid expansion in the first half of this year established the strong forward momentum for the economy, but very high levels of interest rates and the maturing of the expansion are expected to slow growth. Output is expected to grow 6.6 percent for the four quarters of 1984 and 2.8 percent next year (see Table 2). Under this the growth forecast, the average unemployment rate would decline to slightly less than 7 percent in 1985, compared to about 7.5 percent this year.

According to CBO projections, inflation will accelerate moderately both this year and next. The Consumer Price Index will rise 4.5 percent this year and 5.2 percent in 1985, compared to 3.3 percent in 1983. The principal reason for this acceleration is that some of the factors holding down the rate of inflation are not expected to continue, notably the appreciation of the dollar and weakness in the prices of crude oil and food raw materials.

Interest rates remain high in the CBO forecast, in part because of the large federal deficits reflected in current policies. The three-month

TABLE 2. THE CBO FORECAST FOR 1984 AND 1985

	Actual		Forecast	
	1982	1983	1984	1985
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	2.7	10.4	10.9	8.2
Real GNP	-1.5	6.3	6.6	2.8
GNP Implicit Price Deflator	4.3	3.8	4.1	5.3
Consumer Price Index, Urban Consumers	4.5	3.3	4.5	5.2
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.7	9.6	7.3	6.7
Three-Month Treasury Bill Rate	10.6	8.6	10.0	9.7
Corporate Bond Rate, Moody's AAA	13.8	12.0	13.1	12.3

Treasury bill rate averages 10.0 percent in 1984 and declines only slightly to 9.7 percent in 1985, despite the substantial slowdown in economic growth. Long-term rates, as measured by the AAA corporate bond rate, average 0.8 percentage points lower next year than this year, in part because the underlying inflation rate continues to be moderate in the forecast.

Projections for 1986 through 1989

The CBO economic projections for 1986 through 1989 are summarized in Table 3. These projections are not necessarily consistent with current budget policies. They simply assume moderate noncyclical growth rates based on historical experience. In the projection, economic growth averages 3.1 percent per year for 1986 through 1989. For the entire seven-year period from the end of 1982 to the end of 1989, the implied annual growth rate is 4 percent--the same as the average for the seven years following the troughs of the first six postwar recessions. Given this kind of growth, the civilian unemployment rate edges down to an average of 6.3 percent in 1988. Projected inflation remains virtually flat for 1986 through 1989, at approximately the rate forecast for 1985. Interest rates decline slightly between 1985 and 1986, and then remain flat for the rest of the projection period. Since inflation is also flat, real interest rates are assumed to be constant.

Uncertainties in the Outlook

The major uncertainties in CBO's forecast center around the behavior of inflation and interest rates over the next 18 months and the response of the economy. Some analysts believe the current economic expansion could be nearing a point where resource constraints will lead to intensified inflationary pressure. Other analysts are concerned that the Federal Reserve has been focusing too much on reducing inflation. Nevertheless,

TABLE 3. MEDIUM-TERM PROJECTIONS FOR CALENDAR YEARS 1986-1989

Economic Variable	Actual	Forecast		Projected			
	1983	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)	3305	3683	4004	4329	4687	5064	5466
GNP (percent change, year over year)	7.7	11.5	8.7	8.1	8.3	8.0	7.9
Real GNP (percent change, year over year)	3.7	7.3	3.6	3.1	3.3	3.1	3.0
GNP Implicit Price Deflator (percent change, year over year)	3.8	3.9	4.9	4.9	4.8	4.8	4.8
CPI-U (percent change, year over year)	3.2	4.4	5.0	4.9	4.8	4.8	4.8
Civilian Unemployment Rate (percent)	9.6	7.3	6.7	6.6	6.4	6.3	6.3
Three-Month Treasury Bill Rate	8.6	10.0	9.7	8.9	8.9	8.9	8.9
Corporate Bond Rate (Moody's AAA)	12.0	13.1	12.3	11.5	11.5	11.5	11.5
Corporate Profits a/ (percent of GNP)	6.8	7.9	7.9	8.1	8.1	8.0	8.1
Wage and Salary Disbursements (percent of GNP)	50.2	49.2	49.1	49.0	48.9	48.7	48.6
Other Taxable Income b/ (percent of GNP)	19.0	19.7	20.0	20.1	20.1	20.1	20.0

SOURCE: Congressional Budget Office.

a/ Corporate profits with inventory valuation and capital consumption adjustments, on a national income and product accounts basis. To arrive at "book" profits, the basis for tax estimates, these adjustments are removed.

b/ Other taxable income consists of personal interest income, including interest on the public debt, rent, dividends, and income of unincorporated businesses.

with the moderate growth projected by CBO, and in the absence of inflationary shocks that are not now foreseen, changes in the inflation rate in the near-term seem likely to be moderate.

The exchange rate of the dollar presents another but related element of uncertainty. The CBO forecast assumes that strong credit demands and relatively high U.S. interest rates will keep the dollar near its current level, and that we will continue to rely heavily on foreign capital to help finance large federal deficits. A curtailment, however, of net capital inflows--either because of reduced confidence in the United States or enhanced opportunities in other countries--would cause a fall in the dollar's value. That, in turn, would put upward pressure on both domestic inflation and interest rates.

THE BUDGET OUTLOOK

CBO's latest baseline budget projections continue to show rising federal deficits during the next five years, from an estimated $172 billion for 1984 to $178 billion in 1985 and $263 billion by 1989 (see Table 4). These projections take into account recent Congressional action on the Deficit Reduction Act of 1984 and several other budget measures, as well as our current economic forecast and longer-run assumptions. They do not take into account, however, the effects of any enacted 1985 appropriations, but these are not likely to change the outlook significantly.

While still disturbing, the budget outlook has improved during the last six months, largely as the result of legislative action. Last February, CBO projected that, given the spending and taxing policies in place at that time, the federal budget deficit would grow from $189 billion in 1984 to $197 billion in 1985 and to $308 billion by 1989. Our latest baseline projections for the six-year period 1984 through 1989 are cumulatively $166 billion lower. Enacted legislation accounts for $142 billion of this reduction. Revised economic assumptions--largely higher interest rates--add $62 billion for the period, but technical reestimates offset $40 billion of this increase. Together, these legislative, economic, and technical changes yield savings in debt service of $46 billion.

The effect of the legislative action has been to stabilize more-or-less the deficit relative to the size of the economy. As shown in Table 4 and portrayed in Figure 1, baseline deficits are now projected to decline from 4.8 percent in 1984 and then to rise slowly to 4.9 percent by 1989. This contrasts with our February projections of 5.3 percent in 1984, 5.0 percent in 1985, and 5.7 percent in 1989.

These deficits would cause the federal debt held by the public nearly to double from an estimated $1.3 trillion at the end of 1984 to $2.5 trillion by the end of 1989. The ratio of debt to GNP would increase from 36 percent in 1984 to 46 percent by the end of the decade--the highest since the early 1960s (see Figure 1).

The outlook for the level of goverment debt is especially worrisome. Many analysts believe that the stock of debt relative to GNP, rather than the deficit per se, works most directly to affect the level of interest rates,

TABLE 4. CBO BASELINE BUDGET PROJECTIONS
(By fiscal year)

	1983 Actual	1984 Base	Projections				
			1985	1986	1987	1988	1989
In Billions of Dollars							
Revenues	601	673	751	811	881	965	1,042
Outlays	796	845	929	1,006	1,097	1,203	1,305
Unified Budget Deficit	195	172	178	195	216	238	263
Off-Budget Deficit	12	11	14	14	15	16	15
Total Deficit	208	183	191	209	231	254	278
As a Percent of GNP							
Revenues	18.6	18.7	19.1	19.1	19.2	19.4	19.4
Outlays	24.7	23.5	23.7	23.7	23.9	24.2	24.3
Unified Budget Deficit	6.1	4.8	4.5	4.6	4.7	4.8	4.9
Off-Budget Deficit	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Total Deficit	6.4	5.1	4.9	4.9	5.0	5.1	5.2

and through them the level of private investment. The continuing increases in the debt/GNP ratio that are implied by current policy therefore threaten us with persistent upward pressure on interest rates, and the danger that federal borrowing will crowd private investment out of the financial markets. In addition, as a consequence of the growing debt levels, net interest costs are projected to double almost over the next five years—rising from an estimated $111 billion in 1984 to $214 billion in 1989. Net interest costs are now the most rapidly growing item in the federal budget.

As a percentage of GNP, these costs are projected to rise from 3.1 percent in 1984 to 4.0 percent in 1989 (see Figure 1).

Revenue and Outlay Projections

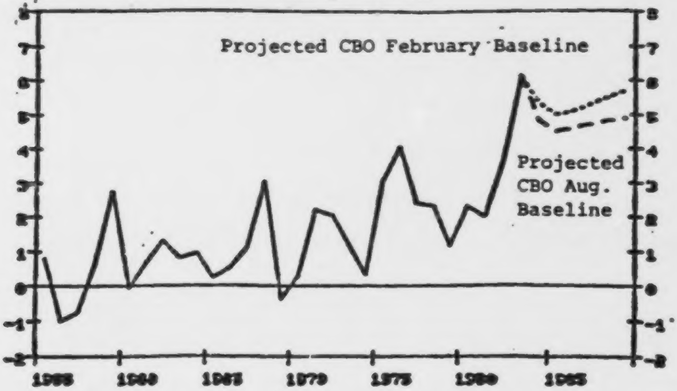
CBO's baseline budget projections are designed to show what would happen to the federal budget if current policies were continued in the future. For revenues and for mandatory spending items, current policies are defined largely by the laws now in effect. For discretionary spending, however, the definition of current policy is not as clear, since appropriations are made for only one year at a time. Because action is still underway on the 1985 appropriation bills, our August projections merely updated our February projections for revised economic and technical assumptions.

CBO projects baseline revenues will rise from $673 billion in 1984 to $751 billion in 1985 and $1,042 billion in 1989. During this period, revenue growth is projected to be somewhat faster than the assumed growth in GNP. Consequently, revenues as a percent of GNP would rise from 18.7 percent in 1984 to 19.1 percent in 1985 and 19.4 percent in 1989.

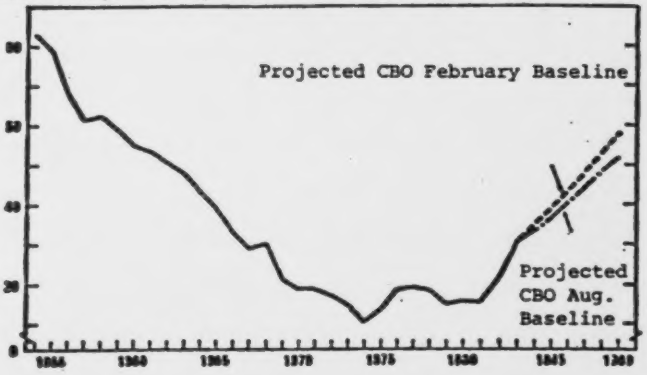
The projected stream of revenues is more than $100 billion higher for the 1984-1989 period than CBO estimated last February. Almost all of the increase can be attributed to the revenue provisions in the Deficit Reduction Act of 1984. Strong economic growth this year has resulted in a higher revenue estimate for 1984, but for 1985 through 1989 economic and technical revisions to our baseline projections are mostly offsetting.

FIGURE 1. SELECTED FISCAL MEASURES, 1955-1983 AND PROJECTIONS FOR 1984-1989 (FISCAL YEARS)

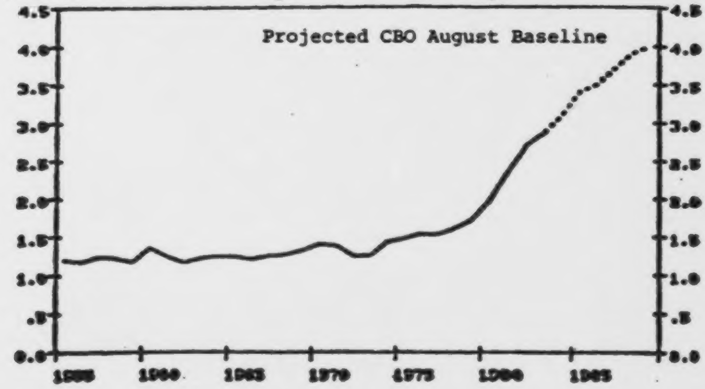
Federal Deficit as a Percentage of GNP



Federal Debt Held by Public as Percentage of GNP



Federal Net Interest Payments as Percentage of GNP



SOURCE: Congressional Budget Office.

Under CBO projections, the composition of federal revenues would change marginally over the next five years. Individual income taxes and social insurance taxes would grow from 80 percent of total revenues in 1984 to 83 percent by 1989. Corporation income taxes would increase slightly in relative importance, while excise taxes and other revenues would continue to diminish in importance (see Table 5).

CBO baseline revenues are defined as revenues generated under existing tax law, with the exception of the assumed extension of certain trust fund taxes. CBO assumes that hazardous substance response trust fund (superfund) taxes will be extended at current rates beyond their scheduled expiration date in 1985; airport and airway trust fund taxes beyond 1987; and highway trust fund taxes beyond 1988. These assumed extensions account for $14 billion of CBO baseline revenues in 1989. In other words, if the Congress were to allow these taxes to expire on schedule, 1989 revenues would be $14 billion below the baseline estimates shown here.

Because all other temporary provisions of existing law are assumed for these estimates to expire on schedule, a decision to extend any of these provisions would alter projected baseline revenues. If the Congress were to extend all of these revenue-raising provisions, such as the temporary increases in cigarette and telephone usage excise taxes, while allowing all of the temporary revenue-losing provisions to expire, revenues would be $4 billion above the current baseline estimate by 1989. On the other hand, if the Congress were to extend all of the temporary revenue-losing provisions,

TABLE 5. BASELINE REVENUE AND OUTLAY PROJECTIONS BY SOURCE OR MAJOR CATEGORY (By fiscal year, in billions of dollars)

	1984	Projections				
	Base	1985	1986	1987	1988	1989
Revenues by Source						
Individual Income Taxes	302	342	375	411	454	498
Corporate Income Taxes	60	66	73	86	91	96
Social Insurance Taxes	239	268	290	311	345	372
Excise Taxes						
Windfall Profit Taxes	8	7	6	5	4	4
Other	29	32	30	31	31	30
Estate and Gift Taxes	6	6	5	5	5	5
Customs Duties	11	13	13	14	15	15
Miscellaneous Receipts	17	18	19	19	20	21
Total Baseline Revenues	673	751	811	881	965	1,042
Outlays by Major Category						
National Defense	230	262	293	327	366	406
Entitlements and Other Mandatory Spending						
Social Security	175	185	197	211	227	243
Medicare	62	70	78	88	100	113
Other	158	162	171	178	187	195
Subtotal	396	417	446	477	514	551
Nondefense Discretionary Spending	155	164	171	181	190	199
Net Interest	111	134	150	169	194	214
Offsetting Receipts	-47	-48	-54	-58	-61	-66
Total Baseline Outlays	845	929	1,006	1,097	1,203	1,305

SOURCE: Congressional Budget Office.

while allowing expiration of temporary excise taxes (except the three trust fund taxes, extended in the baseline), 1989 baseline revenue would be $11 billion below the estimate shown here. These temporary provisions and their treatment in the CBO baseline are summarized in the box below.

Baseline outlays are now projected to rise from $845 billion in 1984 to $929 billion in 1985 and $1.3 trillion by 1989. The growth in outlays between 1984 and 1989 averages 9 percent per year, slightly more than the assumed rate of increase in GNP for this period. Consequently, total outlays as a percent of GNP rise from 23.5 percent in 1984 to 24.3 percent in 1989.

CBO's August baseline outlay projections for 1984-1989 are about $60 billion or 1 percent lower than our February estimates. Legislation enacted by the Congress before its July recess reduced outlays by $38 billion for the six-year period; about half of this resulted from the Deficit Reduction Act. Technical reestimates also reduced projected outlays by $25 billion, but revised economic assumptions--largely higher interest rates--increased projected outlays by $50 billion. The effect of these changes in the outlay projections, together with changes in the revenue projections, is to reduce projected deficits by $120 billion for 1984 through 1989. This reduction, in turn, provides additional savings in debt services costs amounting to $46 billion.

Under our baseline assumptions, changes in the compositon of federal spending are more substantial than for revenues. With large and growing

CBO BASELINE TREATMENT OF TEMPORARY REVENUE PROVISIONS

Type of Provision	Expiration Date	Extension Assumed in Baseline
Revenue Raising Provisions		
Trust Funds		
Hazardous Substance (Superfund)	9/30/85	Yes
Airport and Airway	12/31/87	Yes
Highway	9/30/88	Yes
Post Closure Liability	9/30/85	No
Other Excises		
Cigarette	9/30/85	No
Telephone	12/31/87	No
Revenue Losing Provisions		
Energy Tax Incentives	12/31/85	No
Other Tax Incentives		
Research and Development Credit	12/31/85	No
Targeted Jobs Credit	12/31/85	No
Non-Itemizers' Deduction for Charitable Contributions	12/31/86	No
Small Issue IDBs	12/31/86	No
Employee Stock Ownership Plan Credit	12/31/87	No
Six-Month Holding Period for Long-Term Capital Gains	12/31/87	No
Others	12/31/84--12/31/88	No
Net Effect on 1989 Baseline Revenues of		
Provisions Assumed to be Extended		+$14 billion
Provisions Assumed to Expire		+ $7 billion

deficits and no reduction in inflation-adjusted interest rates after 1985, net interest costs would nearly double over the next five years. They would rise from 13 percent of total outlays in 1984 to 16 percent by 1989. Assuming a 5 percent annual real growth in defense budget authority (as was done for our February baseline projections), defense spending would also rise as a share of the budget—from 27 percent in 1984 to 31 percent in 1989. While outlays for entitlements and other mandatory spending programs are projected to increase by $155 billion between 1984 and 1989, their portion of the budget would fall from 47 percent to 42 percent. Social Security and Medicare account for three-fourths of the projected increase in entitlements, and about 27 percent of total spending.

Sensitivity of the Budget Projections to Economic Assumptions

Budget estimates are sensitive to relatively small changes in economic assumptions. This can be illustrated by showing the effects of a one percentage-point change in some of the key economic variables, such as real GNP growth or the level of interest rates. This is done in Table 6.

If interest rates are one percentage point higher than assumed for the CBO projections, the baseline budget deficits for 1985 would be higher by $4 billion and for 1989 by $26 billion. On the other hand, if real growth is one percentage point higher than was assumed for the CBO projections throughout the 1985-1989 period, the baseline deficit for 1985 would be $9 billion lower and the 1989 baseline deficit would be reduced by $105 billion.

The results shown in Table 6 should not be interpreted as alternative economic scenarios. Sustained changes in one economic variable do not generally occur without changes in other variables as well. Also, it should be noted that a one percentage-point change in both variables was assumed as a convenience and not to reflect typical forecasting errors. Interest rates tend to be volatile and difficult to forecast, especially in recent years.

TABLE 6. THE EFFECTS ON BASELINE BUDGET PROJECTIONS OF HIGHER REAL GROWTH AND INTEREST RATES (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989
Real Growth: Effect of One-Percentage-Point Higher Annual Rate Beginning October 1984					
Change in revenues	8	22	38	56	77
Change in outlays	-1	-4	-9	-17	-28
Change in deficits	-9	-26	-47	-73	-105
Interest Rates: Effect of One-Percentage Point Higher Annual Rates Beginning October 1984					
Change in revenues	1	1	1	1	1
Change in outlays	5	10	15	22	27
Change in deficit	4	10	14	21	26

SOURCE: Congressional Budget Office.

Although real growth rates fluctuate greatly from year to year, they tend to be more stable over five-year periods. Hence, a one percentage-point average error in projecting interest rates is more probable than a one percentage-point error in projecting real growth rates over a long period of time.

CONCLUSIONS

Despite high interest rates, the near-term outlook for the economy is bright. Most forecasters expect the recovery to continue through next year, with only a moderate acceleration in inflation. The high level of the federal deficit, however, remains a serious problem. While the deficit as a percent of GNP has been roughly stabilized, under current policies the debt would grow much more rapidly. That threatens to put persistent upward pressure on interest rates. In addition, servicing that debt promises to become a crushing burden unless policies are changed.

Chairman ROSTENKOWSKI. Thank you very much, Dr. Penner. I must say your forecasts for 1985 are rosy in my opinion. This committee tries to write legislation to provide economic balance. I just hope that the members of this committee will have the long view in mind as opposed to just focusing on the short run.

Mr. Conable will inquire.

Mr. CONABLE. Mr. Chairman, I would like to ask Rudy about the issue of the value of the dollar. I wonder if one of the greatest threats to the rather comfortable statistical prognosis you make is not the possibility that something will occur to cause the value of the dollar to slump and therefore a sharp outflow of foreign capital which as we all know could occur in a much shorter timeframe than any improved competitiveness for American goods in the world and our domestic market.

We could easily have suddenly a sharp decline in the available supply of money for investment in both the public and the private sector and thus could have a sharp spike in interest rates. That is one thing that is expressed to me as a real possible fly in the cream here, and I am wondering if you would comment on that possibility. I realize that there are lots of Cassandras around and that just because that is a possibility doesn't mean it necessarily happens, but there is some talk that that should be the—one of the major concerns we have at this time, and that the possibility should quite possibly also affect our public policy rather than the more comforting suggestions you have made about next year's probable statistical landscape.

Mr. PENNER. That is exactly right, sir. In CBO's August report and in my more complete testimony today, I think it is fair to say we judge the number one risk to our rather optimistic forecast as emanating from the international sector.

As I said, we have benefited greatly from being able to borrow from international capital markets. It has kept our interest rates lower than they would otherwise be. It has kept the dollar higher than it would otherwise be, and thus has kept inflation lower.

Obviously, it hasn't been without cost. The high dollar has been very painful for our trading industries, but nevertheless, it has been of benefit to us. Now if that should change, we would have the reverse situation—a lower dollar, higher inflation, higher interest rates—and that could be very painful.

I think the real issue is why the change occurs and how fast. Obviously, it would be much easier to adjust to if it were to occur gradually than if it were to occur abruptly. And it would be more likely to occur gradually if it happened as the result of what I would suggest would be good reasons.

For example, one reason might be a higher rate of growth in Europe that would attract more investment there or, perhaps best of all, a change in our fiscal policy that would take some pressure off our capital markets and thus take pressure off interest rates. But you are absolutely right: If there is anything to worry about in all of this, I think a sudden change in capital inflows is No. 1.

We could also be wrong about the capacity in the economy. There could be more acceleration of inflation than we forecast, but we as a risk would rank that, I think, a bit lower than the risk of an abrupt change in the capital inflows.

Mr. CONABLE. Thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Dr. Penner, what is our prime interest rate now?

Mr. PENNER. Thirteen percent—I am sorry. It is a split now. I think most banks are still at 13 percent.

Mr. PICKLE. Roughly 13 percent, plus or minus. Your testimony indicates that interest rates are high and may go up. Do you have an estimate for how much you think they are going up?

Mr. PENNER. No, sir. Our forecast is for a 10-percent average rate for, say, 90-day Treasury bills this year, which implies rates that would be very little different than they are today, perhaps marginally higher. Then, because of the economic slowdown and what we forecast as a reduced demand for private credit needs, we forecast that they will come down very marginally to 9.7 percent on average next year.

Mr. PICKLE. I don't feel like I have a handle on your answer. Do you think the interest rates are going to go up?

Mr. PENNER. No, sir, not in our forecast.

Mr. PICKLE. We passed deficit reduction bills of about $98 billion in 1982, and then this year about $50 billion plus a reduction in spending, yet I haven't felt that these efforts have lowered the deficit. The forecast is that the deficit will go up to 200-some-odd billion dollars in the next 5 years. Has our deficit reduction bill helped us? Now we kind of lose sight of the fact that we have done this and gone through all that agony if the deficit remains so high.

Mr. PENNER. It was my interpretation before I came to CBO that those changes were extraordinarily helpful. At that time, I was forecasting deficits that absolutely exploded before TEFRA was passed. I believe it helped a lot. I think that the Deficit Reduction Act passed this year has helped much more than is generally perceived.

As I said in my statement, according to our estimates, along with the reconciliation bill and others, it will reduce the deficit in the late 1980's by almost a full percentage point of the GNP. What is important about that is now it is stable, whereas in our February projections it was going up and up. So I would suggest that what has been done legislatively has been extraordinarily helpful.

Mr. PICKLE. Dr. Penner, we have to hope that is the case or else we have gone through a great deal of anguish to no avail. Yet when we come to hearings like this and look at the big picture of what has to be done, we ask ourselves where has this big assistance from 1982 and 1984 been swallowed up? Do you think the high deficit is related to the 3-year tax cut that we gave?

Mr. PENNER. It is always very hard to associate a dollar of deficit with a particular dollar of policy change. I think it is obvious that the tax cut reduced the tax burden as a proportion of GNP, while spending continued to rise as a proportion of GNP. Part of the problem was not the tax cut per se but the fact that when it was designed, everyone, including the administration, presumed a much higher rate of inflation over time than we have actually experienced. So the rate cut, which we had earlier expected would be offset to a considerable degree by bracket creep, turned into a much larger real tax cut than was anticipated.

The depreciation change was designed to offset the erosion of depreciation allowances by inflation but it turned out again to be much more generous than we had anticipated. So the fact that the legislation turned out to be a larger tax cut than we ever thought was very important in all of this.

Chairman ROSTENKOWSKI. Mr. Gephardt will inquire.

Mr. GEPHARDT. Thank you, Mr. Chairman.

Mr. Penner, in the ending part of your testimony, you talk about what would happen if you had a different growth scenario than the one you project.

I guess the big debate this year, and certainly next year, is going to be whether or not that growth is going to occur, and whether or not that higher growth scenario would occur if we changed the revenue path, and the outlay path.

As you know, many argue that we can grow our way out of this deficit and that we don't need to change budgetary policy. Indeed, as you say, if you have 1 percent more growth that deficit in 1989, instead of $263 billion would be $158 million.

So, my question is, if we enacted next year some kind of a spending slowdown and revenue increase package that would theoretically get you to a level of a similar percent of GNP on both the revenue and the spending side, say 21, 22 percent of GNP, probably 22 percent of GNP, do you project that growth would be what you say it is in this projection or would it be greater, or would it be lesser?

Mr. **Penner**. As you say, sir, there is enormous controversy about that, both political and academic. To some degree, it would depend on how it was done.

Assuming that it was done very gradually and that the monetary authorities were quite skillful in adjusting to it—and there would be some academic dispute about exactly what that would mean—I do not anticipate that it would be a problem.

As you well know, it would be very hard to get that much of a reduction. At that level, we would be somewhat concerned about the shock effect. But presuming it would be done sensibly, not with an absolutely absurd tax policy or absurd changes in spending, I would not be greatly worried that it would shock the rate of growth of aggregate demand in a way that would cause real problems.

Mr. **Gephardt**. Some would even argue that if we reduced revenues even further than we have reduced them now, in other words, reduced them below present law, that we could increase the growth scenario.

Do you subscribe to that?

Mr. **Penner**. Well, again, it would depend on what else was done and how it was done. Assuming nothing else was done, I think that the concern over the deficit implications of a general cut in tax revenues would have a bad psychological effect. But even without that, it would simply drain more and more capital out of the marketplace.

I am not denying that tax cuts per se have an incentive effect, but it is important to set them against both the psychological and real effects on the deficit.

Mr. **Gephardt**. My last question is that if a revenue increase and spending slowdown package were put together, do you believe that a VAT revenue increase would have a different effect on the economy than simply increasing the income tax?

Or would there be any difference in terms of economic outcome?

Mr. **Penner**. I think there clearly would be a difference in the longer run, presuming we are talking about a VAT of the consumption tax variety. In the longer run, one would expect an income tax that raised the same amount of revenue to be somewhat more detrimental to private savings.

In the very short run, it is generally assumed that a sales tax increase of any kind, whether it be VAT or retail sales tax, would have a once and for all impact on the price level that would be more than a similar increase in the income tax.

That is generally presumed, though I am not absolutely certain of it myself. If you look at the recent British experience with various increases in their VAT, some of those have shown up rather quickly in the price levels, whereas others have not.

In pure theory, such an increase could equally well manifest itself in a slowdown in the rate of wage and profit growth as well. It doesn't necessarily have to go into prices, though, as I say, that is the usual presumption.

Mr. **Gephardt**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Duncan will inquire.

Mr. **Duncan**. Thank you, Mr. Chairman.

Dr. Penner, how does your present optimistic forecast compare with your forecast about a year ago?

Mr. **Penner**. If you compare it to last February's forecast, we have increased the real rate of growth during 1984 and reduced it somewhat in 1985. But when you add those two things together, the result is somewhat more real growth over that period.

Unfortunately, and probably in a related way, that increase in real growth has raised our interest rate projections. Thus, in terms of the effect on the budget, when everything is added up, it is almost a wash.

Mr. **Duncan**. You were a little bit more pessimistic at that time, I think, than you are today, is that correct?

Mr. **Penner**. Yes, for the 2-year period, a little more.

Mr. **Duncan**. Economic growth in itself, I think we all can agree, will not generate sufficient funds to balance the Federal budget, but do you think we can ever balance it unless the Congress learns to say no and slows down the growth of expenditures or appropriations?

Mr. **Penner**. I think it is absolutely clear, sir, that if you accept the first proposition, then the only way we can get the deficit down is either to slow down the growth of spending or raise revenue.

Mr. **Duncan**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Matsui will inquire.

Mr. **Matsui**. No questions.

Chairman **Rostenkowski**. Mr. Heftel will inquire.

Mr. **Heftel**. Thank you, Mr. Chairman.

Mr. Penner, I think, in the pressure for tax reform and deficit reduction, we will have some movement to consider repeal of the investment tax credit, ACRS, capital gains. Do you think that repeal of those tax provisions would impact adversely if done in a short-time frame on our so-called economic growth?

Mr. **Penner**. Again, sir, I think that what else goes on at the same time is crucially important. Or maybe a better way to put it is that if you start with the assumption that you are going to raise some revenues, the alternatives are some new tax like the VAT, some rate increases, or some base broadening. I presume changing depreciation would fall into that last category.

The question of whether to charge depreciation depends crucially on what you compare it with. What you have to ask is whether it would be better or worse than, say, some increase in general tax rates. You could obviously think of changing both rates and depreciation in a way that would leave the total taxation of capital higher, and you might say at first sight that that would reduce the economic growth rate.

One of the problems, however, with the depreciation structure that we have today is that it favors some kinds of capital very much more than others, and, of course, there are literally dozens of provisions in our tax laws that do the same.

If we could change that and tax different kinds of capital income more equally from different assets, the implication would be that we would allocate the capital stock more efficiently, because it would go where private productivity was higher rather than where there was a better tax advantage.

One can easily envision reforms that might reduce the rate of capital formation in the aggregate and therefore make one worry a little bit about future economic growth. But if the reforms were structured in a way that our capital stock was used much more efficiently, there would be some offset, and that could be very important.

It is very hard to estimate these things empirically as to where one would come out on a net basis. In my view, however, one of the very worst characteristics of our current tax system is the extraordinary difference in the tax rate on different types of capital, whether it is corporate or noncorporate, whether it is equity financed or debt financed, whether it is in equipment or structures or inventory. All of these things make an enormous difference in the tax paid, and in turn that results in an extraordinarily inefficient allocation of capital in our society.

Mr. HEFTEL. Are you then saying, in effect, we could carefully look at how we modify capital gain, ACRS, ITC to maintain a sense of balance and not have an adverse impact, but if we were to arbitrarily eliminate them without careful thought about consequences, it might produce a counterproductive result?

Mr. PENNER. I think that is exactly right, and it is a less long winded way of putting it than my response.

Mr. HEFTEL. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Dr. Penner, when I went to south Arkansas during the last district work break, practically every stop I made, I had constituents asking me, can we grow our way out of the Federal deficit?

I know Mr. Gephardt asked you some questions about it and I know that it is addressed in your testimony. Nevertheless, would you restate your answer in short straightforward language that my constituents can understand?

Can we grow our way out of the deficit picture between now and 1989?

Mr. PENNER. If you had asked me that question last February, I would have said it is just so implausible as to be really not anything that one should even remotely hope for. But the deficit reduction actions taken this year were significant enough that it is now less implausible. Let me put it that way.

I think you would have to make extraordinarily optimistic assumptions, but you would not have to make assumptions that are outside of the range of our postwar history.

So, if you just ask me, is it possible for us to grow our way out of the deficit, I would say yes. If you ask me, is it probable, I would say no. You would have to be an extraordinary optimist to reach that conclusion.

Mr. ANTHONY. So, if I were going to take the modest course, the conservative course, the most surest of courses, then I would be safe to tell my constituents that it is not very likely that we are going to grow our way out of it?

Mr. PENNER. I think that is exactly right, especially if by growing our way out of it, you are really talking about a balanced budget by 1989. If you were talking about 2 percent of GNP or something, that would change the probabilities.

Mr. **Anthony**. All right. Now that I have stood up in front of these people and I have told them we can't grow our way out of it, I say we have several choices: We can cut spending, we can have a combination of spending reductions and tax revenues, or we can just do it all on the tax revenue side. Personally, I don't think it is politically likely that we are going to do it all on the tax revenue side, so for the moment, let's take revenues out of it.

How much would we have to change current policies if we took it out all on the spending side?

Mr. **Penner**. If we took it all out of the spending side——

Mr. **Anthony**. To get all the way to a balanced budget.

Mr. **Penner**. I think the most relevant table in my testimony for that purpose is table 4 on page 10. It shows that by 1989, outlays would reach 24.3 percent of the GNP, whereas revenues would be 19.4 percent.

So, crudely speaking, what we are talking about is getting that spending line down by 5 percentage points. That would be roughly a 20-percent cut by 1989. You could phase it in gradually obviously, but by then, there would have to be a 20-percent cut in all spending programs.

One has to remember the interest on the debt, of course, and that there are a lot of long-term contracts. So, in terms of what you could cut, it would be something above 20 percent of all the programs. And that, of course, is assuming no feedback on the economy, which is a pretty courageous assumption.

Mr. **Anthony**. So, if I understand you, you are saying we have about 20 percent of the budget that we can cut on the spending side?

Mr. **Penner**. Taking you to mean literally making that spending path meet the tax path the answer is yes.

Mr. **Anthony**. That means we would have to get 100 percent of what we need out of 20 percent of the path?

Mr. **Penner**. No, maybe I have lost you here. I am saying the total, the aggregate amount of outlays would have to be cut.

Mr. **Anthony**. 20 percent?

Mr. **Penner**. 20 percent, yes.

Mr. **Anthony**. Fine. Thank you.

Mr. **Penner**. Another way of putting it is simply that in our projections, receipts are covering only about 80 percent of outlays.

Chairman **Rostenkowski**. Mr. Gradison will inquire.

Mr. **Gradison**. No questions, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Thomas will inquire.

Mr. **Thomas**. Thank you, Mr. Chairman.

It is my understanding that a short rephrasing of your response to Mr. Gephardt would be that it is possible for us to fine tune our way out of it on both the revenue and the spending side; is that correct?

Mr. **Penner**. I think that is a fair statement.

Mr. **Thomas**. On the revenue side, in terms of the fine tuning, from your perspective, we should be doing some simplification as well as additional revenue?

Mr. **Penner**. I think that the vast majority of economists, regardless of their ideology, would agree that the main thing wrong with our current tax system is that we have so many deductions and credits and exclusions that we tax a small proportion of total economic activity. Therefore, we have very high rates of taxation. In other words, it is the rate of taxation on your extra bit of work effort or your extra bit of savings that creates the disincentives in the system.

I think you would find widespread agreement among economists that the way to proceed is to have very broadly based taxes.

Mr. THOMAS. We have some fundamental reforms that have been offered, conceptually different from what we have now, with the consumption taxes from Mr. Heftel, Mr. Gephardt's ideas. It seems as though these fundamental revisions, as opposed to fine tuning, all have as a common theme and are touted, I guess, as a virtue, that they are revenue neutral.

From your perspective, does it make a lot of sense to go through the political problem of fundamentally adjusting our tax system to come up with a revenue neutral system.

Mr. PENNER. I think that is a judgment that involves a purely political forecast, which I guess you are all more expert in making than I am.

As Mr. Conable said in his opening statement, it is the conventional political wisdom that to have fundamental tax reform you must have an aggregate tax cut. Whether that is really true or not is another matter. I think there may have been some exceptions to that in recent years.

I am really perhaps stretching the point a bit, but I think in very general terms one can consider the 1982 and 1984 acts as having considerable base-broadening measures. And we did use those to raise revenues. I just have to let you judge whether you could do that more radically.

Mr. CONABLE. Would the gentleman yield?

Those tax bills would not affect the average citizen. Only in a very peripheral way.

Mr. PENNER. You are absolutely right. There were a number of fairly small changes that, in the end, added up to a very large amount of money.

Mr. THOMAS. Do you think, in terms of your willingness to give us some prudent advice, even if it is in the political area, that if we engage in discussion, examinations of fundamentally different systems, that we ought to look at something other than the narrow goal of deficit reduction—my point being that I don't think we get to restructure every 5 years—I hope we don't restructure every 5 years.

If we are going to go through this process, ought we not to be looking ahead as well to where we think the Federal Government might be in the latter part of the 20th, or even the first part of the 21st century, as we restructure, rather than focusing entirely on the question of dealing with the deficit under the current structure the Federal Government has. Is that a worthwhile pursuit?

Mr. PENNER. I think it is, absolutely, sir. There is no doubt in my mind that the way we reduce the deficit is extraordinarily important, both from the point of view of economics and from the point of view of political value.

Indeed, that is what this whole argument is about in my judgment. It is about what the Federal Government should be responsible for and who should pay for it. And that is a political argument.

On the economic side, one wants to be very concerned about the efficiency of what is done, both on the spending and the tax side, and what kind of incentives that creates for work and savings and all those other important things.

So, as I said to Mr. Heftel, one of the goals should be to try and keep the tax rates on different kinds of activities as even as we can, subject, of course, to value judgments about income distribution and other things we might want to do.

But I think the point you raise is important; namely, the way in which we reduce the deficit is critical.

Chairman **Rostenkowski**. Mr. Guarini will inquire.

Mr. **Guarini**. Thank you, Mr. Chairman.

Mr. Penner, little has been said, but you did mention the international situation. Our trade deficit, of course, now has gone to an unprecedented $130 billion, which translates in terms of jobs, probably to several million jobs.

On your chart did you assume a trade deficit of more than $133 billion? I would imagine that we are talking about GNP; we are talking about production, and jobs, bringing ourselves back to a sound economy, our foreign trade is an important part of that equation.

Mr. **Penner**. Essentially, our analysis assumes that the dollar will stabilize and that there will be very high trade deficits as we go on through 1985; after that, we pretty much straightline it.

The thing to remember, of course, is that the trade deficit is just a mirror image of capital inflow. The two cannot be judged separately. So while you are absolutely right that the trade deficit has imposed a great deal of pain on our trading industries, the capital inflow has enabled us to maintain a much higher level of capital formation than we would have had otherwise, and that in turn has been good for us.

Mr. **Guarini**. When you say straightline, aren't we in unusual times, where normally inflation would be 2 percent lower than your interest rates, but now there is a big gap. Aren't these times much different than those you traditionally chart?

Mr. **Penner**. You are certainly right about that. Our interest rates through the whole period—our short rates in real terms—are far above historical experience. Furthermore, as I said in my prepared statement, they are extraordinarily important to the budget outlook simply because the debt outstanding has become very large. A 1-percentage point error in our interest forecast means a $26 billion error by 1989 in forecasting the budget deficit.

So you are right to identify that as a crucial assumption. We don't pretend that the long-term projections are exactly consistent with the fiscal policy. But given that we are restricted to forecasting and projecting on the basis of current law, we cannot help but be influenced by the current fiscal policy, and, therefore, we did not think we could rationalize bringing the real interest rates way down to historical levels.

Mr. **Guarini**. Mr. Penner, I have very little time, so I just want to get into a few quick points. I have spoken with a number of

CEO's who indicated to me that they are very concerned about the hard dollar, about wages that are comparatively high in our country, and their not being competitive with foreign countries.

And they have indicated that they are starting a crash program of building plants overseas. Now, here is another aberration—where we were once a Nation that; colonized, we are now in the position where we are going to lose additional jobs by having factories built in overseas locations by our large national corporations which are taking advantage of the world economic market.

Do you see any problem there in our having a productive economy and a higher employment rate in the future?

Mr. PENNER. I see a somewhat greater problem on the other side of that; namely, that we could become very dependent on the capital inflow, and that will cost us. We would have to pay for that in the future with interest and dividends, and that would lower our standard of living in the future.

Mr. GUARINI. But is that cranked into your thinking?

Mr. PENNER. Yes.

Mr. GUARINI. And just lastly, are you concerned about our opportunity to borrow from the international markets, and how long can we borrow from the international markets without hurting ourselves and our economy.

Mr. PENNER. As I said, our assumptiom is that we can continue to borrow.

Mr. GUARINI. Indefinitely?

Mr. PENNER. That is one of the most tenuous assumptions in our whole outlook. As I said earlier, we isolate that as the No. 1 risk.

Mr. GUARINI. Where is the end of our being able to borrow from international markets? Do you see a terminus period?

Mr. PENNER. The answer to your question depends on how many dollars foreigners are willing to hold in their portfolios. Right now, they have great confidence in us.

We are one of the most politically stable places in the world. We are growing faster than the Western European countries. It really is a question of how long they have that confidence. Of course, as long as there are prospects of economic growth, you can be a debtor nation for decades.

Mr. GUARINI. I wish I could share your optimism. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Dr. Penner, a number of exporting companies located in New York City are complaining that the strength of the U.S. dollar is having a disastrous effect on their ability to export. But on the other hand, I guess you are saying that the strength of the dollar combined with high interest rates attracts, foreign investment which cushions the impact of the deficit.

You indicate that one of the fears we could have is that there would be a sharp decline in foreign investment. Our exporters—what can we promise them? They say we are losing business and export opportunities because of cheaper priced European and other foreign goods.

They are not only losing dollars, but they are losing technology, in that it may, in the long run have a very bad effect on the U.S. industrial economy.

Mr. **Penner**. Well, sir, that is the down side of the capital inflow. We have gone through very painful adjustment problems. My reading of the data would be that the current situation has been even more painful for firms competing with imports than it has been for the exporters. The exporters are not doing well, but they are doing remarkably well, I think, given the value of the dollar.

In our judgment, and it is somewhat controversial, the trade deficit is very closely linked to the Federal budget deficit. That is to say, the Federal budget deficit puts pressure on our capital markets, raises interest rates, attracts foreign capital, and, of course, raises the value of the dollar. Obviously, if you have a capital inflow, you have to have some sort of trade deficit on the other side.

Now, of course, if you accept that argument, it implies that if we lower the deficit in the long run, we would also lower the trade deficit. I have to say that there are some people who would disagree 180 degrees with that analysis.

They would say, if we lower our budget deficit, foreigners would have even more confidence in this country, the money would just pour in, the dollar would rise further, and that would make things even harder for the export firms. But if that happened, I think it would be safe to forecast an absolute plunge in real interest rates in this country and that would be extraordinarily beneficial for us. Indeed, it is even conceivable that some firms who are heavy users of capital could come out better in the end. But as long as there is a capital inflow—for whatever reason—we will have that trade effect on the other side.

Mr. **Rangel**. My point is, suppose we don't do anything about the deficit, we do have sharp interest rates or at best stabilizing as you forecast, that we do have a continued investment from foreigners, and we really destroy our competitive edge in terms of our manufacturers trying to export overseas.

Is there anything that you figure we could do, even though we are being bailed out by foreign investments as relates to this $200 billion deficit—I understand that. And I don't want to see a sharp decline in foreign investment to cause all of the terrible things that you forecast would occur.

But what do we do about American business? Do they now become just victims of high deficits, high interest rates, foreign investment, a strong dollar?

Mr. **Penner**. As I say, what we do has to balance. So if you are thinking of doing something for individual trading firms, through tax advantage or subsidies or something similar, obviously you could improve their prospects, but then the problem would be pushed to other areas of the trade account.

If I take your question literally and assume everything will go on as it is today—then it is inevitable that we are going to have a trade deficit.

You can ask whether that is a contradiction in terms—that if things literally go on as they are today—there might be some point at which the foreigners do in fact lose confidence in us. Then capital inflows will start to dry up, interest rates will go up here, the dollar will fall, and so forth. That is good for your trading firms, but it is bad for the economy as a whole.

Mr. **Rangel**. It just doesn't sound as rosey as your initial testimony made it sound. It seems as though we are paying a terrible price to avoid another recession, and that is we are relying totally on foreign investments in order to keep going.

Mr. **Penner**. I would not say totally, sir, but we are relying on them very heavily. Over the next couple of years, we do not expect that to cease.

Chairman **Rostenkowski**. Mr. Frenzel will inquire.

Mr. **Frenzel**. Thank you, Mr. Chairman.

Mr. Director, we are delighted to have you here. We appreciate your valued testimony. I would like to go back to your dialog with Mr. Anthony, in which he talked about how we are going to get out of our mess, and whether we could grow out of it and so forth.

I notice, going back to your table on page 10, that there may be more hope for getting out of it without a major reliance on taxes than a lot of people seem to believe.

You frightened him with the 20-percent cut, but I don't think you told him how fast your baseline spending increases. It looks to me like you are going up by 8 percent a year until you get to 87 and 88 when you are up to the 9- and 10-percent level.

So we are not talking about cuts at all. What we are talking about is some slowdown of the baseline to get where we are going. Is that not correct?

Mr. **Penner**. That is absolutely right. Perhaps I should have noted before, for example, that our baseline does assume a 5-percent real increase in defense. It does assume that entitlement programs will remain as they are today, so that there is inherent growth in them.

So you are right. What we are talking about is a slowdown in the growth, or a cut from the way we interpret current losses.

Mr. **Frenzel**. Can you see any reason why competent managers need to expand their expenditures in the 8- to 10-percent range over the next 5 years at a time when deficits are to many Americans the No. 1 problem in the country?

Mr. **Penner**. Well, as I said before——

Mr. **Frenzel**. Is the baseline some sort of message engraven in tablets of marble?

Mr. **Penner**. No. As I said before, I truly think it is a political value judgment as to what you think Government should be doing. Though we have to make a lot of arbitrary assumptions, the baseline essentially continues implicitly the values we have in place now, as we interpret them. But obviously there is no reason that one has to continue with that.

Mr. **Frenzel**. And also if one wanted to achieve a balance in 1989, theoretically one could do so by refusing spending, and one would, assuming all the other things are equal, and they are not of course—one would still be spending more in 1989 than we have contracted to spend in 1985.

Mr. **Penner**. That is true in nominal terms.

Mr. **Frenzel**. I agree with you. It is not true in normal terms.

My problem, Dr. Penner, is that I don't agree with our friend from Missouri that tax increases are inevitable or even necessary. They may be inevitable politically, but economically they are in my judgment not inevitable.

It just depends on what kind of choices we make here. Could you give me some help on that revenue figure?

You show revenues over the baseline period in your table increasing about 5 percent. You show outlays staying the same. What has been our revenue figure historically?

You leave it in 1989 at 19.4 percent of GNP. Was it not about a percentage point lower than that for the decades of the sixties and the early seventies?

Mr. **Penner**. It was certainly lower than that in the 1950's. I think at times in the 1960's we came up to that level. In fact, I believe we even surpassed it in the Vietnam surtax era. It jumps around a little bit.

But very roughly speaking, I guess it probably averaged a little below 19 percent in the 1970's, and 18.5 percent in the sixties. I may have to correct that. But it was around 19 percent in the seventies, and it surpassed 20 percent in 1980.

Mr. **Frenzel**. Where did it max?

Mr. **Penner**. It reached its height at 20.8 percent in 1981.

Mr. **Frenzel**. Is that calendar or fiscal?

Mr. **Penner**. Those are fiscal years.

Mr. **Frenzel**. Thank you very much, Dr. Penner. I happen to be one of those who don't believe the deficit is the fault of the taxpayers, and hope the committee won't consider that it is.

Chairman **Rostenkowski**. Mr. Pease will inquire.

Mr. **Pease**. Thank you, Mr. Chairman.

Dr. Penner, I noted that this week or last week that a group of business economists were a little skeptical that the recovery would last more than about 9 months or through late 1985. Are you able to put a degree of probability at all on the possibility of a recession sometime in 1985?

Mr. **Penner**. Personally, I think the probability is really quite low, especially if we were to have no shocks of any kind. Obviously, if we had what is very unlikely—an oil shock for example—then very probably a recession would follow. But we certainly don't expect anything like that.

Mr. **Pease**. There has been a good deal of discussion in this committee and elsewhere about trying to reduce the deficits projected over the next several years by a combination of spending restraints or cuts and revenue increases.

If there were to be another recession, it would be very difficult to do that. The conventional wisdom in the past for a recession has been that you reduce revenues by cutting taxes and increase expenditures either through social insurance programs or by pump priming.

And yet that goes directly contrary to what we are thinking of doing in order to reduce the deficit. If we were to get into another recession within a year or a year and a half, what should be the appropriate policy on the part of Congress?

Would we have to revise—reverse our policy, and let the deficits grow? Or would we be advised to try to reduce the deficits, even in the face of a recession?

Mr. **Penner**. The argument you gave, sir, is enunciated very often. In assessing it, I think it is extremely important to reflect on how slowly we really do things on the fiscal side.

There are long timelags between the point legislation is passed and the point when it actually has an impact on outlays. If you were to pass a tax bill early next year, for example, most of it would probably be effective January 1, 1986, and it would not affect 1986 fiscal revenues all that much.

Even if you are very Keynesian in your views and believe that budgets should be used to stabilize the economy, I think you have to be very cognizant of the enormous timelag. Presuming a normal recession—and they don't last that long on average—then it would be my judgment that you should not be constrained from discussing what in Keynesian terms is defined as a tightening of fiscal policy, because the critical impact of that tightening would be fairly far down the road.

Obviously, I would modify that to some degree to take account of the expectational effects of anything that you might do. But I think the traditional view just ignores the enormous timelags involved in all of this.

Mr. PEASE Well, you would grant, I hope, that psychologically and politically it would be very difficult to tighten the fiscal restraints in a recessionary period.

Mr. PENNER. That would be the older view. Things have changed so much in the economic profession that it is even conceivable to me—though I don't think it would necessarily be right—that the deficit might be blamed for whatever contraction occurred. That would be very unusual in economic theory, but one hears that argument around from time to time.

I think things have changed very radically from the time when the views you have described were generally believed. You are absolutely right—that used to be generally believed. But I think it is a new world now.

Mr. PEASE. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Campbell will inquire.

Mr. CAMPBELL. Thank you, Mr. Chairman.

Dr. Penner, let me revisit a couple of the questions that have been raised before now.

You were talking about a 1-percent increase in interest rates and the impact that it would have. The 1-percent growth rate increase above your projection in the GNP, how much does that reduce the baseline figure?

Mr. PENNER. Well——

Mr. CAMPBELL. Just assume you were 1-percent lower on that.

Mr. PENNER. According to table 4 on page 16 of my testimony, that would change the deficit by 1989 by $105 billion. Frankly, I am always concerned about that table. There are a number of problems with it.

First of all, a 1 percentage point error in forecasting real growth, while a nice round number, is much less likely than a 1-percentage error in forecasting interest rates.

Mr. CAMPBELL. That is true. But the 1 percent would reduce that 1989 baseline by $105 billion.

Mr. PENNER. Yes. Now, in computing that table, we are assuming that a 1-percentage point error comes from the demand side of the economy, so that the increase in growth would cause a very large reduction in unemployment and, therefore, we would save a lot of money on unemployment compensation and other welfare programs. You can see from the chart that the spending side of that change is $28 billion.

If that change in the growth rate were to come, however, through some surprising increase in productivity to the economy so that we could grow at that rate with lower employment, a smaller labor force, then we would not get a big reduction in unemployment.

Under those circumstances, very crudely speaking, it would be better just to look at the revenue line, where you would get $77 billion.

Mr. CAMPBELL. OK. Let me ask you this. In your projections of the growth of Federal spending, assume that that was reduced one percent, what does that give us?

Mr. PENNER. I am sorry, sir. If you were to reduce——

Mr. CAMPBELL. From your level, 24.3.

Mr. PENNER. Are we dealing with a 1-percentage point reduction of the spending?

Mr. CAMPBELL. What if you came in at 23.5—1-point lower than you are talking about?

Mr. PENNER. I don't have an exact calculation of that. But if it were to happen instantaneously—we are talking about the impact over a 5-year period—very crudely speaking you would have a little above a 5-percent cut by 1989, so that is $65 billion.

Mr. CAMPBELL. So, in effect, if Federal spending grew about 1-percentage point lower than you are projecting, we would have about $65 billion, and if the economy grew and the GNP grew about 1 percent higher, and even using your worse case scenario, because productivity grew and you did not get the savings——

Mr. PENNER. I would hate to call that a "worse case."

Mr. CAMPBELL. I would, too. But from an employment standpoint. But you have in those two, you have $130 billion, $140 billion roughly different in your baseline figure for 1989.

Let me go the tax side just a minute. As we look at the tax program, and Mr. Gephardt mentioned the VAT a little bit earlier, I want to ask you what do you see as a possible way to get the revenue into the Government from the $400 to $500 billion that IRS tells us is out there that is not taxed—other than going to some type of consumption tax.

Do you know any other way to get it in?

Mr. PENNER. I think there are a number of points one can make about that. First of all, a large part of that money is in illegal activities, like drug trade and so on, which makes it extremely hard to identify.

Mr. CAMPBELL. That money is spent ultimately somewhere, isn't it?

Mr. PENNER. Yes. But I think that is very hard to get through any device, except by preventing the illegal activity.

You can obviously consider spending more on IRS enforcement. Various studies show a big yield from more audits. But you have to be very careful. You don't want to harass the population. You have to be very cognizant of how many innocent people you harass to catch the guilty. In my judgment the whole problem would be reduced—though not eliminated—if there were a broader base, a simpler system with lower tax rates.

Mr. CAMPBELL. That would mean that the people carrying the burden today would be called upon to carry less of a burden than they might be if you broadened it; is that correct?

Mr. PENNER. I think so. Right now, for every dollar a person cheats on at the top, he or she saves 50 cents in taxes, and that becomes the incentive for cheating.

To the extent you could lower the marginal tax rate one way or another, the incentive for cheating would be lower. I also think the opportunity for cheating would be lower if there were fewer deductions and exclusions and less complexity in the law.

Mr. CAMPBELL. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Archer will inquire.

Mr. ARCHER. Dr. Penner, in your opinion can we grow our way out of this deficit without major adjustments in spending and/or taxes?

Mr. PENNER. I think, sir, as I said somewhat earlier to Mr. Anthony, if you had asked me that question last February, I could have responded with a flat no. We have done enough, however, over the year in the way of deficit reduction—reducing the deficit by 1 percentage point of the GNP—that it has really been quite important quantitatively. So one can no longer say it is impossible. At the same time, you have to be extraordinarily optimistic to get that result.

Mr. ARCHER. If taxes were reduced, would the revenue from growth in your opinion outpace the obvious nominal loss of revenue from reducing the taxes?

Mr. PENNER. Most evidence would suggest that if there were a generalized tax cut, the answer would be no. You might find some taxes in the system that are so oppressive that it could occur in isolated instances, but not as a general rule.

Mr. ARCHER. In your opinion, how much can taxes be increased without being counterproductive to a net positive revenue impact?

Mr. PENNER. It is absolutely crucial how you increase taxes. In the judgment of most economists, anything that increases the rate of taxation is more economically inefficient than anything that would broaden the tax base and thereby enable you to apply lower rates to obtain a given amount of revenue.

Obviously, as Mr. Conable suggested in his opening statement, if you really feel strongly about the various social and economic purposes that are served by the various exclusions and so on, then you may make a judgment that the direct effects of inefficiency are worth bearing. But as a general principle, increasing the tax rate is more inefficient than increasing the base.

Mr. ARCHER. But if you could design the tax so that it would be the least offensive economically, how much increased revenue do you think our economy could absorb from taxes without it being counterproductive in one year's time?

Mr. PENNER. Well, that is an extraordinarily difficult question to answer. Many countries go on with tax burdens much higher than ours. How far you could go is, I think, basically unknown.

Mr. **Archer**. You don't have any real considered opinion on how much we could increase the tax take assuming the taxes were designed in a way that would be the best in your opinion.

Mr. **Penner**. When I look at a country like Sweden that has, as you know, extraordinary tax rates—marginal rates on fairly ordinary people of, say, 80 percent—I wonder how it continues at those kinds of levels. But it does, somehow or another.

I cannot imagine such high rates being considered tolerable in this country. Nevertheless, we do have the counter-example of Sweden.

Mr. **Archer**. If you had to choose between a 1-percent increase in taxes or a 1-percent reduction in spending, which do you think would be the most beneficial in an overall economic sense as far as the welfare of this country is concerned?

Mr. **Penner**. If by "overall economic sense" you mean all of social welfare, that is the kind of question that an economist simply cannot answer. It is really a question about what role Government should play in our society—should it play a bigger role, doing more things, or should it play a lesser role?

That choice has economic implications, and I would suggest the implications again depend crucially on what kind of tax, what kind of spending, and so forth.

Mr. **Archer**. Without trying to get into all those ramifications, but in a simpler economic sense as to whether we would have a higher increase in the GNP, let's say.

Mr. **Penner**. Again, I don't think you can generalize. It depends what you do on each side.

Some sorts of spending increases add to productivity. Others subtract from productivity. In some isolated instances, certain tax increases add to efficiency. As a general rule, however, they detract from economic efficiency.

Mr. **Archer**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Dr. Penner, we thank you very much for sharing your time with us. We appreciate it very much.

The Chair calls Dr. Kaufman and Mr. Rohatyn. Gentlemen, welcome to the committee. It is always a pleasure for us to have you share your views with us. I hope that this exchange will be informal and that time will not be of very great consequence. I will invite members of the committee to join in exchanges with you after you have presented your statements.

It is a pleasure for us to have you here. I want to express my personal gratitude for your appearance. I know how valuable your time is. However, I think you recognize the importance of the deficit issue. That is why I am happy that you have agreed to participate in these discussions.

Dr. Kaufman, you may proceed.

STATEMENT OF HENRY KAUFMAN, EXECUTIVE DIRECTOR, SALOMON BROS., INC.

Mr. **Kaufman**. Thank you, Mr. Chairman.

As you know, I am vice chairman of Phibro-Salomon Inc. and an executive director of Salomon Bros., Inc., where I am also in charge of our three research departments. Your invitation to give my assessment of the Federal budget deficit comes at a time when there is a great need to focus objectively on this crucial problem.

If the economic expansion is to endure beyond a typical cyclical life, if the development of new fragilities in our financial system is to be avoided and if economic and financial rehabilitation abroad is to continue, then it is essential that we make substantial progress in reducing the deficit.

While Government spending and taxation are political and social issues, as well as economic, we should be alert to the probability that extreme political polarization on budgetary matters may result in a stalemate. The consequence would be the continuation of an imbalance in stabilization policies, thus threatening our economic well-being.

Despite the heightened rhetoric in this election year, this committee, and other members of Congress, can now contribute much in the way of analysis and planning for the budgetary legislation that is required promptly next year.

In my testimony to you this morning, I shall cover three aspects of the problems associated with the budget deficit: first, the impact of the large budget deficit so far; second, the likely consequences of continued large deficits; and third, the strategy for achieving an improved budget position.

I believe that nearly all would agree that the most positive aspect of the huge budget deficits of recent years has been its contribution to the economic recovery in the United States. Large tax cuts and sharp increases in Federal outlays—especially in defense—have helped to lift the country out of a long, deep recession. After a hesitant start, consumer spending lept ahead and has been joined recently by a strong increase in business outlays.

However, the budget today differs markedly from the budgets in the past. First, the fiscal stimulus in 1985, calculated on the basis of a high-employment deficit of $145 billion, or 3.5 percent of gross national product, will be unprecedented—particularly since the economy will already be in the third year of a cyclical upswing.

Second, even if we assume that economic growth can be maintained at a steady pace through the rest of the decade, the deficit under current policies, at close to 5 percent of GNP, will remain extraordinarily high relative to the economy.

By comparison, in the 1960's the deficit averaged only 0.5 percent of GNP and in the 1970's it was barely 2 percent of GNP. In these two decades, the deficit never totaled more than 4 percent of GNP.

Third, the discretionary budget outlays, which are subject to annual appropriations, are a much smaller part of the total than ever before. In 1984 nondefense discretionary or controllable outlays represented only 18 percent of overall spending and at least 40 percent of that amount encompassed outlays for the Nation's infrastructure and the day-to-day operations of Government. By the end of the decade, this controllable portion of outlays will shrink to 14 percent.

It is unfortunate that the economic and financial costs associated with large budget deficits are substantial and difficult to reverse while the benefits of the deficit are both immediate and vivid.

The deficit has retarded the cyclical interest rate decline, preempted the supply of long-term funds, contributed to new patterns of finance that will increase market risk and volatility, checked U.S. exports and will shorten the duration of the economic expansion if fiscal policy is not reversed.

I am convinced that if there had been much smaller budget deficits in the past few years, then a much lower level of interest rates would have resulted. The drop in interest rates would have been greater and the rise since early last year would have been smaller.

With lesser deficits and with the modest private credit demands that are usually associated with recessions and the early phases of business recovery, monetary policy would have had to step up its effort to restimulate the economy much more so than it did under the actual fiscal policy that prevailed.

The Federal Reserve would have had to inject substantial reserves into the banking system, thus lowering interest rates to levels that would have reignited the economy. Instead, we have had an economy stimulated by huge budget deficits, reflecting large Government spending and tax cuts, and an occasionally hesitant monetary policy. Interest rates fell, to be sure, but the decline was inhibited by the huge borrowing needs of the U.S. Government.

A recent official study attempted to invalidate the impact of the budget deficits on interest rates. It concluded that there is no correlation between changes in Government borrowing and changes in interest rates.

This conclusion was based on the observation that when the deficits tend to be large in economic recessions, interest rates still fall, and when the deficits tend to be small in economic expansions—excluding the current one—interest rates still rise. This observation fails to consider a more important issue in the present cycle, namely: How much lower would interest rates be now if the deficit in recent years had been much smaller?

A recent study by Morgan Guaranty Trust Co. undertook to quantify the answer to this question. Through the use of a well-known economic and financial model, Morgan estimated the yield trend of 5 year Treasury obligations.

As a basis for its analysis, Morgan assumed that fiscal programs that existed in the first quarter of 1981—just prior to the start of substantial fiscal stimuls—had remained in effect. Morgan found that 5-year Treasury issues would have yielded 9.39 percent instead of the actual 11.64 percent in the first quarter of 1984.

I believe that this interest rate would have been even lower, in part, in part because Morgan's analysis was also based on conservative assumption that the monetary course in recent years would have remained unchanged. Given the deep recession and the urgency for an economic recovery, a much more substantial monetary expansion would have been likely—especially over a short-time interval.

I do not claim that the budget deficit has been the sole cause of recent high interest rates. At least two related causes have left their mark on the structure of interest rates.

The first, financial deregulation, including the removal of interest rate ceilings, has enabled many important financial instituitions to bid for funds under all market conditions and to invest the proceeds in a much wider range of investments and loans than would have been possible years ago, when financial markets were highly structured.

When monetary policy tightens in this new environment, few financial institutions need to limit their activities. By quickly passing on the cost of funds to the final demanders of credit, such as businesses and households, the financial intermediaries have minimized their own risk in interest rate fluctuations; they thus strive to maintain growth and substantial credit creation whether monetary policy eases or tightens.

This process has also been facilitated by a second factor-financial innovation—including the many variations of floating interest rate arrangements and new marketable credit instruments. These obligations have enabled borrowers to persist with their credit demands for a much longer period than ever before.

And, as I just noted, the new floating interest rates have enabled financial intermediaries to quickly pass on rising interest rate costs to final demanders of credit. There are two negative consequences: Interest rates must climb to very high levels to curb the private sector economic participants, and in the process, households and businesses are encumbered with volatile and topheavy debt structures. Thus while financial institutions escape from taking interest rate risks, they are eventually saddled with financial assets that are deteriorating in credit quality to a greater or lesser degree.

In my opinion the emergence of the huge Federal debt has contributed importantly, both directly and indirectly, to financial innovation and to changes in financing procedures that are detrimental to the private sector.

For example, the rise of a futures market in U.S. Government securities has enhanced market making and the distribution of Government obligations because futures facilitate arbitraging and hedging and thus limit the risks in the actual cash markets. The average daily volume of transactions in Government futures has totaled $27 billion thus far this year—equal to 54 percent of the cash transactions in outstanding Governments.

No other fixed-income sector has such a highly developed futures market. The corporate bond market and municipal market must use Government futures, a condition that is far from satisfactory, because the interest rate relationships to the Government market vary considerably and both of these private markets have great diversity in credit quality. As a result, corporates and municipal markets operate at a relative disadvantage.

The cascade of new Government offerings, especially longer-dated intermediate and long Governments, has also contributed to the sharp increase in floating-rate financing by households and businesses and to the decreasing popularity of long-term fixed-rate borrowings in these two sectors.

Today, the long-term taxable bond market is dominated by the U.S. Government. This was not always true. In 1977, new issuance of Governments with maturities of 20 years and longer totaled only $4 billion compared with an estimated $36 billion this year.

In contrast, business corporations are depending increasingly on short-term borrowing and on the issuance of intermediate fixed-rate and floating-rate debt. In 1977 new publicly offered long-term corporate bonds with fixed interest rates totaled $17 billion or 77 percent of total public straight corporate bond issues.

Last year, they amounted to $11 billion, or 29 percent of total corporate bond issuance. Thus far this year, long-term, fixed-rate offerings have equaled just $2.2 billion, or 8 percent of public corprate bond issuance.

Thus, conventional corporate bond issuance has contracted, while new U.S. bond financing has expanded. At the same time, adjustable-rate mortgages now represent 68 percent of new private conventional home mortgages, compared with 30 percent in early 1983. Of course, this type of mortgage financing was not yet available in 1976.

Consequently, households and businesses—which comprise the two key private sectors in our economy—are now subject to wide swings in interest rate costs and the resultant financial uncertainty. Thus a larger number of private borrowers are assuming greater risks than ever before.

The Government has, therefore, been instrumental in pushing households and businesses out of the traditional long-term bond market, the great pride of the U.S. credit system that in its past vitality had once embodied confidence in the Nation's economic and financial stability.

The shortcomings in a policy of continued large budget deficits will come into sharp focus when the economic expansion achieves greater maturity. Up until now, the deficit limited the fall in interest rates and caused shifts in the structure of financing arrangements.

In the next phase, however, the deficit will start to crowd out private demanders of credit and will drive their debt servicing burden higher. Private credit demands are currently rising, reflecting the lift in economic activity.

This is evident in business and household borrowing, which has been rising sharply this year.

These demands have exerted upward pressure on interest rates—pressure that has been exacerbated by the continued large borrowing needs of the U.S. Treasury. As the economy moves into the third year of expansion, external financing requirements of business will continue to mount.

The emerging shortfall between internal cash generation and the funds required to finance capital outlays, inventories, and receivables will grow. In the household sector, credit needs will continue to rise in order to finance consumer goods and services and it will be mortgage financing that will bear the brunt of the crowding from Government borrowings and the rising debt service burden.

The mirror image of these rising private sector credit demands is seen in the current and prospective behavior of major financial institutions. In the recent business recession and early months of the current economic recovery, financial institutions, in the absence of strong credit demands from the private sector, replenished their liquidity through substantial purchases of U.S. Government securities.

However, as private credit demands reasserted themselves this year, liquidity building has stopped. In fact, several major institutions have been net sellers of Government instruments.

Most importantly, commercial banks are now net sellers of Governments. In contrast, they had purchased $65 million net in the 1982–83 period.

Thrift institutions, which in 1982–83 had bought $26 billion of Governments net, are close to becoming net sellers in the second half of this year. It is not realistic to expect U.S. financial institutions to return as big buyers of Government securities in 1985.

As noted earlier, private credit demands are rising, thus offering either more attractive opportunities to financial intermediaries or requiring them to honor private sector loan commitments, or both.

Who, then, will finance the U.S. Treasury? Our Government will, of course, always attract sufficient funds given the high credit standing of the instruments and its ability to pay the interest rate required. This will require increasing dependence on funds from households, whose savings are already being significantly diverted into Treasury bills and notes.

During the first 2 years of this business recovery, households' direct net purchases of U.S. Governments totaled an estimated $162 billion, or 47 percent of the net increase in privately held Treasury debt—an unprecedented proportion of households' savings for the first and second year of a business recovery. In 1975–76, a comparable economic period, households bought only $22 billion, or 17 percent, of the Treasury's debt issuance. Imagine the positive impact that such funds would have had on interest rates had they been employed in the financing of private sector activity in the absence of a large budget deficit.

The savings of foreigners—a very volatile source of funds—is now helping to finance the growth in U.S. economic activity. The flow of these moneys into a variety of investments rose from $9 billion in 1982, to $42 billion in 1983, and to an annual rate of nearly $90 billion in the first half of 1984. While this shift of funds to the United States has aided our economic recovery, continued dependence on foreign savings is a necessity in the absence of a significant reduction in the budget deficit, since the savings of businesses and households are insufficient. These private sector savings are being offset by the dissavings of the U.S. Government.

To continue to finance our economic expansion will require either the generation of much larger savings by the private sector or the creation of substantial inducements to foreigners to commit additional funds to U.S. investments. The former, I believe, is unlikely, given our historical pattern of savings generation, while the latter will require highly competitive interest rates not only to attract new foreign funds, but also to retain foreign funds that are already in the United States.

This is a high-risk policy for us and for the rest of the world, and such a struggle for foreign savings could intensify when major industrial nations improve the pace of their economic recoveries. Indeed, their recoveries could be impeded by the rise in interest rates associated with this type of competition, as could the recovery in developing nations, which are already laboring under the pressures of U.S. interest rates and of the strong dollar in foreign exchange markets.

Today, U.S. economic stabilization policies—fiscal and monetary—are at odds with those of major industrial nations. Government borrowings (including those of State and local governments) as a percentage of GNP totaled 3.9 percent in 1982–83 and an estimated 3.1 percent this year. In Japan and West Germany, these ratios will be down to 2.3 percent and 1.4 percent respectively, this year.

Domestic credit growth is still accelerating in the United States, while it is slowing in several key industrial nations. The 12 percent estimated annual rate of credit growth in the United States during the first half of 1984 exceeds that of West Germany, Japan, France, and Canada and matches that of Britain.

The United States is also stepping up its effort to sell Treasury obligations to foreigners. This approach could have several ramifications. The funds that the Treasury will capture abroad will either be transfers out of foreign currencies into U.S. dollars or, alternatively, shifts in dollar investments. To the extent that this financing attracts net new dollar funds, the dollar—currently at or near all time highs against many currencies—will rise even further in the exchange markets. But if the financing produces shifts from other dollar investments to new U.S. obligations, the U.S. Treasury will benefit at the expense of other U.S. sectors.

U.S. dollar deposits held by foreign accounts could be particularly hard hit, and this, in turn, may force banks to raise the interest rates that they pay on deposits. Issuers in the Eurodollar market—both U.S. borrowers and foreigners—will also need to compete with the direct demands of the U.S. Treasury. In addition, this type of financing would accelerate the United States' recent move toward becoming a debtor nation, interest on the national debt would not just be "owed to ourselves" but would become subject to the discipline and uncertainty of international markets.

Without timely and meaningful cuts in the budget deficit, several adverse developments, both here and abroad, will emerge within the next year, as the U.S. economy reaches the more advanced phase of economic expansion. The crowding out phenomenon will become quite visible. The persistence of Treasury financing needs and substantial credit requirements of the private sector will induce higher interest rates and reinforce the downturn in new housing activity.

The rise in interest rates will further blunt the financing flexibility of businesses and increase the financial vulnerability of both businesses and financial institutions. Internationally, higher U.S. interest rates will support the already lofty value of the dollar, complicate the economic recovery in Europe and increase the debt burden of the developing countries.

Yet, what would be the consequences if substantial deficit reductions were legislated? The rally in both stock and bond prices, and the implicit wealth creation, would more than offset the risk of a possible slowdown in business activity. The strong positive financial response would, after a short delay, spur new housing activity and businesses' capital outlays.

But, these new private demands eventually would stem the fall in interest rates initiated by the deficit reduction. The cyclical rise in interest rates would then reassert itself. Why, then, bother with deficit reductions? First, the economic expansion would be prolonged for the period in which interest rates fell and remained below the level that existed before the deficit reduction. Second, we would most likely avoid an extremely harmful interest rate upsurge at the end of the current business expansion.

A hefty budget deficit at the end of an economic expansion, together with typically large private credit demands, will produce an explosion in interest rates that will be difficult to control in a monetary policy setting that must labor in a deregulated credit market. Preventing the damage that such an explosion would effect is, by itself, worth a major reduction in the deficit. Third, the temporary reversal in U.S. interest rates would reduce our reliance on foreign savings, let foreign interest rates fall, and thus promote an improved pace of economic expansion.

In the final part of my testimony this morning, I would like to discuss the strategy for dealing with the budget deficit. The strategy most frequently under discussion calls for a phaseout of the deficit over an extended time—generally about 5 years. This is an unrealistic approach, whose shortcoming lies mainly in that we do not have the analytical skills to project correctly all of the economic and financial variables required for accurate intermediate budget forecasts.

A review of these budgetary projections over the past 10 years provides ample warning to anyone favoring such a procedure. During the past 10 years, the margin of error in budgetary forecasting has increased with the timeframe of the forecasts. Actual deficits exceeded projected budget surpluses or deficits by $27 billion, on average, for projections 1 year out, by $65 billion for budgets 2 years out, by $112 billion for budgets 3 years in the future, by $149 billion 4 years out, and $182 billion for budget estimates 5 years in the future.

Consider also the sizable differences between the deficit projections estimated by the Office of Management and Budget and the Congressional Budget Office for the next 5 years. These differences also widen sharply from the early to the outer years, with the deficit projections of the Congressional Budget Office exceeding those of the Office of Management and Budget by only $11 billion in 1985 and by $124 billion in 1989. They reflect, of course, substantial differences in underlying assumptions.

For example, the OMB assumes average real growth of 4 percent annually, compared with the CBO's assumption of 3.1 percent. The OMB estimates inflation at 4 percent throughout this period, compared with the CBO's 4.8 percent. The administration forecasts that Treasury bill yields will fall steadily to 5 percent by the end of 1989, while the CBO believes that these yields will average 9.7 percent in 1985 and then hold steady at 8.9 percent through 1989.

It is doubtful that either of these long-term projection will prove correct. Typically, economic expansions endure for 3 years and 8 months and not for 7 years. Inflation and interest rates tend to move up and certainly do not decline in the later stages of economic expansions.

Yet, neither of these 5-year projections includes the elimination of the budget deficit. For 1989, the OMB projects a deficit of $263 billion and the CBO a deficit of $139 billion. Indeed, the economic expansion required to virtually eliminate the deficit without changes in revenues and expenditures is far beyond our reach.

Over the next 5 years, real growth would have to average about 5.8 percent yearly, and inflation would have to average 3.6 percent, as the unemployment rate falls to about 3.5 percent in 1989. Such a feat would be unprecedented. It would defy any historical comparisons.

Today, we are on the threshold of the third year of expansion—not the first. We are pushing against capacity constraints in some sectors, and the availability of skilled help is quite low.

Delaying significant deficit cuts is likely to result in much larger deficits in the future. A delay, as I noted earlier, wiil produce credit market clashes between the demands of the U.S. Treasury and those of the private sector. This will hamper the economic expansion before meaningful deficit reductions will have taken place. The result will be budget deficits of $250 billion to $350 billion, if a recession were to take place in 1986 or 1987. The 5-year strategy will be shelved to deal with the cyclical economic hardships at hand.

What, then is the alternative? I believe it is to reduce the budget deficit sharply—by about $50 billion to $60 billion—within the next 12 month. We are far more certain about economic prospects in this period than we are about conditions 3 to 5 years from now. For every year we delay, we run the risk of having deficit reductions coincide with, and reinforce, the next business recession. In this connection, a most timely opportunity was lost this year.

The salutary benefits of large budget reductions now would more than offset the risk that such a reduction in fiscal stimulus would push the economy into recession. Private sector credit demands would enjoy more room, as interest rates first decline and then rise. Inflation, too, would be dealt a significant blow. The markets would also recognize quickly that they are not hostage to a lasting structural budget deficit. In addition, the U.S. debt management task would be eased, and key sectors of the market, such as new housing activity and business capital formation, would benefit materially.

Think of the positive market response if, after legislating deficit reductions of $60 billion, the Government would announce that it was reducing its gross new long-term bond financing to $10 billion from the current issuance of $36 billion per year.

A quick and substantial reduction of the deficit would go a long way toward limiting the interest expense on the debt. This year, interest expense absorbed more than half of the deficit, and under current policies, interest costs will amount to three quarters of the deficit by the end of the decade. This reflects an insidious chain of kind of self-reinforcing events in which large deficits raise interest costs which in turn create rising structural deficits.

An important initial objective of the deficit reduction effort should be to balance the budget or create a surplus in the accounts net of interest expense. A deficit reduction of $60 billion next year, followed by a further cut of $25 billion in the subsequent year—economic conditions permitting—would achieve this objective.

The choices before Congress are difficult. Substantial deficit reductions in the next 12 months will require both a slowing in Federal outlays and new revenue-raising measures. A dependence primarily on new revenue-raising measures would be self-defeating.

Because we are in an economic expansion, the private sector would initially cope with large tax increases by enlarging borrowings, not by limiting spending.

This would aggravate, rather than ease, credit market conditions. I would suggest a deficit reduction package composed 40 percent of revenue-raising measures and 60 percent of expenditure reductions, with new taxes falling mainly on consumption. In the year following the inception of these measures, other initiatives to reduce the budget deficit should be considered, with the magnitude of this effort depending on current and near-term economic conditions.

In assessing the strategy for reducing the budget deficit, I see the following risks: A large deficit reduction within the next 12 months will, for a short time, temper the economic expansion. It will, however, encourage more balanced and longer economic growth, sharply reduce inflationary expectations, and prevent soaring interest rates at the cyclical peak of economic activity. If we wait until 1985 to undertake budget disciplining action the recession tendencies that will be in the economic system by then will be reinforced.

Adherence to a 5-year plan, calling for modest deficit reductions in the early years and more noticeable results toward the close, would invite clashes between Government and private credit demands in the next few years, thus resulting in extreme financial strains and a subsequent business recession, in which the budget deficit will appear out of control.

Of these three strategies, the most demanding is for Congress to opt for large deficit reductions now. I believe, however, that such a strategy is the correct one.

Chairman ROSTENKOWSKI. Thank you Dr. Kaufman.

[The prepared statement follows:]

STATEMENT OF HENRY KAUFMAN, EXECUTIVE DIRECTOR, SALOMON BROS., INC.

My name is Henry Kaufman. I am a Vice Chairman of Phibro-Salomon Inc and an executive director of Salomon Brothers Inc, where I am also in charge of our three research departments. Your invitation to give my assessment of the Federal budget deficit comes at a time when there is a great need to focus objectively on this crucial problem. If the economic expansion is to endure beyond a typical cyclical life, if the development of new fragilities in our financial system is to be avoided and if economic and financial rehabilitation abroad is to continue, then it is essential that we make substantial progress in reducing the deficit. While Government spending and taxation are political and social issues, as well as economic, we should be alert to the probability that extreme political polarization on budgetary matters may result in a stalemate. The consequence would be the continuation of an imbalance in stabilization policies, thus threatening our economic well-being. Despite the heightened rhetoric in this election year, this Committee, and other members of Congress, can now contribute much in the way of analysis and planning for the budgetary legislation that is required promptly next year.

In my testimony to you this morning, I shall cover three aspects of the problems associated with the budget deficit: first, the impact of the large budget deficit so far; second, the likely consequences of continued large deficits; and third, the strategy for achieving an improved budget position.

Impact of the Large Deficit to Date

I believe that nearly all would agree that the most positive aspect of the huge budget deficits of recent years has been its contribution to the economic recovery in the United States. Large tax cuts and sharp increases in Federal outlays -- especially in defense -- have helped to lift the country out of a long, deep recession. After a hesitant start, consumer spending leapt ahead and has been joined recently by a strong increase in business outlays.

However, the budget today differs markedly from the budgets in the past. First, the fiscal stimulus in 1985, calculated on the basis of a high-employment deficit of $145 billion, or 3.5% of gross national product (GNP), will be unprecedented -- particularly since the economy will already be in the third year of a cyclical upswing. Second, even if we assume that economic growth can be maintained at a steady pace through the rest of the decade, the deficit under current policies, at close to 5% of GNP, will remain extraordinarily high relative to the economy. By comparison, in the 1960s, the deficit averaged only 0.5% of GNP, and in the 1970s, it was barely 2% of GNP. In these two decades, the deficit never totaled more than 4% of GNP. Third, the discretionary budget outlays, which are subject to annual appropriations, are a much smaller part of the total than ever before. In 1984, nondefense discretionary or controllable outlays represented only 18% of overall spending, and at least 40% of that amount encompassed outlays for the nation's infrastructure and the day-to-day operations of Government. By the end of the decade, this controllable portion of outlays will shrink to 14%.

It is unfortunate that the economic and financial costs associated with large budget deficits are substantial and difficult to reverse, while the benefits of the deficit are both immediate and vivid. The deficit has retarded the cyclical interest rate decline, preempted the supply of long-term funds, contributed to new patterns of finance that will increase market risk and volatility, checked U.S. exports and will shorten the duration of the economic expansion if fiscal policy is not reversed.

I am convinced that if there had been much smaller budget deficits in the past few years, then a much lower level of interest rates would have resulted. The drop in interest rates would have been greater, and the rise since early last year would have been smaller. With lesser deficits and with the modest private credit demands that are usually associated with recessions and the early phases of business recovery, monetary policy would have had to step up its effort to restimulate the economy much more so than it did under the actual fiscal policy that prevailed. The Federal Reserve would have had to inject substantial reserves into the banking system, thus lowering interest rates to levels that would have reignited the economy. Instead, we have had an economy stimulated by huge budget deficits, reflecting large Government spending and tax cuts, and an occasionally hesitant monetary policy. Interest rates fell, to be sure, but the decline was inhibited by the huge borrowing needs of the U.S. Government.

A recent official study attempted to invalidate the impact of the budget deficits on interest rates. It concluded that there is no correlation between changes in Government borrowing and changes in interest rates. This conclusion was based on the observation that when the deficits tend to be large in economic recessions, interest rates still fall, and when the deficits tend to be small in economic expansions (excluding the current one), interest rates still rise. This observation fails to consider a more important issue in the present cycle, namely: How much lower would interest rates be now if the deficit in recent years had been much smaller?

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I believe that this interest rate would have been even lower, in part because Morgan's analysis was also based on the conservative assumption that the monetary course in recent years would have remained unchanged. Given the deep recession and the urgency for an economic recovery, a much more substantial monetary expansion would have been likely -- especially over a short time interval.

I do not claim that the budget deficit has been the sole cause of recent high interest rates. At least two related causes have left their mark on the structure of interest rates. The first, financial deregulation, including the removal of interest rate ceilings, has enabled many important financial institutions to bid for funds under all market conditions and to invest the proceeds in a much wider range of investments and loans than would have been possible years ago, when financial markets were highly structured. When monetary policy tightens in this new environment, few financial institutions need to limit their activities. By quickly passing on the cost of funds to the final demanders of credit, such as businesses and households, the financial intermediaries have minimized their own risk in interest rate fluctuations; they thus strive to maintain growth and substantial credit creation whether monetary policy eases or tightens.

This process has also been facilitated by a second factor -- financial innovation -- including the many variations of floating interest rate arrangements and new marketable credit instruments. These obligations have enabled borrowers to persist with their credit demands for a much longer period than ever before. And, as I just noted, the new floating interest rates have enabled financial intermediaries to quickly pass on rising interest rate costs to final demanders of credit. There are two negative consequences: Interest rates must climb to very high levels to curb the private sector economic participants, and in the process, households and businesses are encumbered with volatile and top-heavy debt structures. Thus, while financial institutions escape from taking interest rate risks, they are eventually saddled with financial assets that are deteriorating in credit quality to a greater or lesser degree.

In my opinion, the emergence of the huge Federal debt has contributed importantly, both directly and indirectly, to financial innovation and to changes in financing procedures that are detrimental to the private sector. For example, the rise of a futures market in U.S. Government securities has enhanced market making and the distribution of Government obligations, because futures facilitate arbitraging and hedging and thus limit the risks in the actual cash markets. The average daily volume of transactions in Government futures has totaled $27 billion thus far this year -- equal to 54% of the cash transactions in outstanding Governments. No other fixed-income sector has such a highly developed futures market. The corporate bond market and municipal market must use Government futures, a condition that is far from satisfactory, because the interest rate relationships to the Government market vary considerably, and both of these private markets have great diversity in credit quality. As a result, corporates and municipal markets operate at a relative disadvantage.

The cascade of new Government offerings, especially longer-dated intermediate and long bonds, has also contributed to the sharp increase in floating-rate financing by households and businesses and to the decreasing popularity of long-term fixed-rate borrowings in these two sectors. Today, the long-term taxable bond market is dominated by the U.S. Government. This was not always true. In 1977, new issuance of Governments with maturities of 20 years and longer totaled only $4 billion, compared with an estimated $36 billion this year. In contrast, business corporations are depending increasingly on short-term borrowing and on the issuance of intermediate fixed-rate and floating-rate debt. In 1977, new publicly offered long-term corporate bonds with fixed interest rates totaled $17 billion, or 77% of total public straight corporate bond issues. Last year, they amounted to $11 billion, or 29% of total corporate bond issuance. Thus far this year, long-term, fixed-rate offerings have equaled just $2.2 billion, or 8% of public corporate bond issuance (see Figure 1). Thus, conventional corporate bond issuance has contracted, while new U.S. bond financing has expanded. At the same time, adjustable-rate mortgages now represent 68% of new private conventional home mortgages, compared with 30% in early 1983. (Of course, this type of mortgage financing was not yet available in 1976.)

Consequently, households and businesses -- which comprise the two key private sectors in our economy -- are now subject to wide swings in interest rate costs and the resultant financial uncertainty. Thus, a larger number of private borrowers are assuming greater risks than ever before. The Government has, therefore, been instrumental in pushing households and businesses out of the traditional long-term bond

Figure 1. Volume of New Publicly Offered Corporate Bonds, 1972 and 1976-84 (Dollars in Billions)

	1972	1976	1977	1978	1979	1980	1981	1982	1983	1984
Conventional:										
Greater than 20 Years	$11.1	$16.6	$17.0	$12.2	$14.3	$17.9	$ 8.2	$ 8.6	$11.0	$ 2.2
3-10 Years	3.7	7.0	3.9	4.6	5.5	14.5	15.4	13.8	9.1	10.2
10-20 Years	1.0	0.3	0.8	0.8	0.7	0.8	0.7	1.9	1.3	1.0
Floating Rate, 1-3 Years	--	0.3	0.1	0.4	2.5	0.7	0.3	3.9	5.8	9.8
Convertibles	2.3	0.8	0.4	0.3	0.6	4.0	4.4	2.7	5.9	0.6
Extendables	--	--	--	--	--	--	--	2.0	1.5	3.6
All Other	--	0.2	0.1	0.1	0.2	0.5	4.6	3.5	3.9	1.4
Total	$18.0	$25.2	$22.3	$18.4	$23.8	$38.4	$33.6	$36.4	$38.5	$28.8

*Through August.

market, the great pride of the U.S. credit system that in its past vitality had once embodied confidence in the nation's economic and financial stability.

Prospective Consequences

The shortcomings in a policy of continued large budget deficits will come into sharp focus when the economic expansion achieves greater maturity. Up until now, the deficit limited the fall in interest rates and caused shifts in the structure of financing arrangements. In the next phase, however, the deficit will start to crowd out private demanders of credit and will drive their debt servicing burden higher. Private credit demands are currently rising, reflecting the lift in economic activity. This is evident in business and household borrowing, which has been rising sharply this year (see Figure 2). These demands have exerted upward pressure on interest rates -- pressure that has been exacerbated by the continued large borrowing needs of the U.S. Treasury. As the economy moves into the third year of expansion, external financing requirements of business will continue to mount. The emerging shortfall between internal cash generation and the funds required to finance capital outlays, inventories and receivables, will grow. In the household sector, credit needs will continue to rise in order to finance consumer goods and services, and it will be mortgage financing that will bear the brunt of the crowding from Government borrowings and the rising debt service burden.

Figure 2. Annual Credit Expansion in the United States, U.S. Treasury and Other Borrowers, 1979-84E
(Net Changes in Amounts of Debt Outstanding, Dollars in Billions)

	1979	1980	1981	1982	1983	1984E
Privately Held U.S. Treasury	$32	$76	$78	$152	$175	$172
Other Borrowing	367	276	164	257	362	578
Total	$399	$352	$242	$409	$537	$750

E Estimate.
Note: Total excludes equities and miscellaneous borrowings such as trade credit.

The mirror image of these rising private sector credit demands is seen in the current and prospective behavior of major financial institutions. In the recent business recession and early months of the current economic recovery, financial institutions, in the absence of strong credit demands from the private sector, replenished their liquidity through substantial purchases of U.S. Government securities. However, as private credit demands reasserted themselves this year, liquidity building has stopped. In fact, several major institutions have been net sellers of Government instruments. Most importantly, commercial banks are now net sellers of Governments. In contrast, they had purchased $65 billion net in the 1982-83 period. Thrift institutions, which in 1982-83 had bought $26 billion of Governments net, are close to becoming net sellers in the second half of this year. It is not realistic to expect U.S. financial institutions to return as big buyers of Government securities in 1985. As noted earlier, private credit demands are rising, thus offering either more attractive opportunities to financial intermediaries or requiring them to honor private sector loan commitments, or both.

Who, then, will finance the U.S. Treasury? Our Government will, of course, always attract sufficient funds, given the high credit standing of the instruments and its ability to pay the interest rate required. This will require increasing dependence on funds from households, whose savings are already being significantly diverted into Treasury bills and notes. During the first two years of this business recovery, households' direct net purchases of U.S. Governments totaled an estimated $162 billion, or 47% of the net increase in privately held Treasury debt -- an unprecedented proportion of households' savings for the first and second year of a business recovery. In 1975-76, a comparable economic period, households bought only $22 billion, or 17%, of the Treasury's debt issuance. Imagine the positive impact that such funds would have had on interest rates had they been employed in the financing of private sector activity in the absence of a large budget deficit.

The savings of foreigners -- a very volatile source of funds -- is now helping to finance the growth in U.S. economic activity. The inflow of these monies into a variety of investments rose from $9 billion in 1982, to $42 billion in 1983, and to an annual rate of nearly $90 billion in the first half of 1984. While this shift of funds to the United States has aided our economic recovery, continued dependence on foreign savings is a necessity in the absence of a significant reduction in the budget deficit, since the savings of businesses and households are insufficient. These private sector savings are being offset by the dissavings of the U.S. Government.

To continue to finance our economic expansion will require either the generation of much larger savings by the private sector or the creation of substantial inducements to foreigners to commit additional funds to U.S. investments. The former is unlikely, given our historical pattern of savings generation, while the latter will require highly competitive interest rates not only to attract new foreign funds but also to retain foreign funds that are already in the United States. This is a high-risk policy for us and for the rest of the world, and such a struggle for foreign savings could intensify when major industrial nations improve the pace of their economic recoveries. Indeed, their recoveries could be impeded by the rise in interest rates associated with this type of competition, as could the recovery in developing nations, which are already laboring under the pressures of U.S. interest rates and of the strong dollar in foreign exchange markets.

Today, U.S. economic stabilization policies -- fiscal and monetary -- are at odds with those of major industrial nations. Government borrowings (including those of state and local Governments) as a percentage of GNP totaled 3.9% in 1982-83 and an estimated 3.1% this year. In Japan and West Germany, these ratios will be down to 2.3% and 1.4%, respectively, this year (see Figure 3). Domestic credit growth is still accelerating in the U.S., while it is slowing in several key industrial nations. The 12% estimated annual rate of credit growth in the U.S. during the first half of 1984 exceeds that of West Germany, Japan, France and Canada and matches that of Britain (see Figure 4).

Figure 3. General Government Surplus (+) or Deficit (-) as a Percentage of Nominal GNP/GDP, 1979-85E

	1979	1980	1981	1982	1983	1984E	1985E
United States	+0.6%	-1.2%	-0.9%	-3.8%	-3.9%	-3.1%	-3.7%
Japan	-4.8	-4.5	-4.0	-3.4	-3.1	-2.3	-1.6
West Germany	-2.7	-3.1	-3.8	-3.5	-2.7	-1.4	-0.4
France	-0.7	+0.2	-1.8	-2.6	-3.2	-3.5	-3.5
Britain	-3.2	-3.5	-2.8	-2.1	-3.7	-2.8	-2.4
Italy	-9.5	-8.0	-11.9	-12.7	-11.8	-12.4	-12.9
Canada	-1.8	-2.5	-1.1	-5.3	-5.9	-5.3	-4.6
Total	-1.7%	-2.4%	-2.5%	-4.0%	-4.1%	-3.4%	-3.5%

Source: OECD, World Economic Outlook, July 1984.

Figure 4. Growth of Domestic Credit, 1980-84E

	United States	Britain	West Germany	Japan	France	Canada
1984E	12.0%	12.0%	6.0-6.5%	9.5%	10-11%	7.0%
1983	9.2	12.5	6.7	7.5	13.3	-0.5
1982	7.8	15.5	6.5	19.0	16.1	2.0
1981	8.9	28.2	8.8	10.0	14.1	32.0
1980	7.8	14.3	9.5	8.4	12.3	11.5

E Estimate.
Source: IMF, International Financial Statistics (based on monetary survey data from national sources).

The U.S. is also stepping up its effort to sell Treasury obligations to foreigners. This approach could have several ramifications. The funds that the Treasury will capture abroad will either be transfers out of foreign currencies into U.S. dollars or, alternatively, shifts in dollar investments. To the extent that this financing attracts net new dollar funds, the dollar -- currently at or near all-time highs against many currencies -- will rise even further in the exchange markets. But, if the financing produces shifts from other dollar investments to new Government obligations, the U.S. Treasury will benefit at the expense of other U.S. sectors. U.S. dollar deposits held by foreign accounts could be particularly hard hit, and this, in turn, may force banks to raise the interest rates that they pay on deposits. Issuers in the Eurodollar market -- both U.S. borrowers and foreigners -- will also need to compete with the direct demands of the U.S. Treasury. In addition, this type of financing would accelerate the United States' recent move toward becoming a debtor nation; interest on the national debt would not just be "owed to ourselves" but would become subject to the discipline and uncertainty of international markets.

Without timely and meaningful cuts in the budget deficit, several adverse developments, both here and abroad, will emerge within the next year, as the U.S. economy reaches the more advanced phase of economic expansion. The crowding out phenomenon will become quite visible. The persistence of Treasury financing needs and substantial credit requirements of the private sector will induce higher interest rates and reinforce the downturn in new housing activity. The rise in interest rates will further blunt the financing flexibility of businesses and increase the financial vulnerability of both businesses and financial institutions. Internationally, higher U.S. interest rates will support the already lofty value of the dollar, complicate the economic recovery in Europe and increase the debt burden of the developing countries.

Yet, what would be the consequences if substantial deficit reductions were legislated? The rally in both stock and bond prices, and the implicit wealth creation, would more than offset the risk of a possible slowdown in business activity. The strong positive financial response would, after a short delay, spur new housing activity and businesses' capital outlays.

But, these new private demands eventually would stem the fall in interest rates initiated by the deficit reduction. The cyclical rise in interest rates would then reassert itself. Why, then, bother with deficit reductions? First, the economic expansion would be prolonged for the period in which interest rates fell and remained below the level that existed before the deficit reduction. Several years could be added to the length of the recovery. Second, we would most likely avoid an extremely harmful interest rate upsurge at the end of the current business expansion. A hefty budget deficit at the end of an economic expansion, together with typically large private credit demands, will produce an explosion in interest rates that will be difficult to control in a monetary policy setting that must labor in a deregulated credit market. Preventing the damage that such an explosion would effect is, by itself, worth a major reduction in the deficit. Third, the temporary reversal in U.S. interest rates would reduce our reliance on foreign savings, let foreign interest rates fall, and thus promote an improved pace of economic expansion abroad.

Budget Strategy

In the final part of my testimony this morning, I will discuss the strategy for dealing with the budget deficit. The strategy most frequently under discussion calls for a phaseout of the deficit over an extended time -- generally about five years. This is an unrealistic approach, whose shortcoming lies mainly in that we do not have the analytical skills to project correctly all of the economic and financial variables required for accurate intermediate budget forecasts. A review of these budgetary projections over the past ten years provides ample warning to anyone favoring such a procedure. During the past ten years, the margin of error in budgetary forecasting has increased with the time frame of the forecasts. Actual deficits exceeded projected budget surpluses or deficits by $27 billion, on average, for projections one year out, by $65 billion for budgets two years out, by $112 billion for budgets three years in the future, by $149 billion four years out, and $182 billion for budget estimates five years in the future (see Figure 5).

Consider also the sizable differences between the deficit projections estimated by the Office of Management and

Budget (OMB) and the Congressional Budget Office (CBO) for the next five years. These differences also widen sharply from the early to the outer years, with the deficit projections of the Congressional Budget Office exceeding those of the Office of Management and Budget by only $11 billion in 1985 and by $124 billion in 1989. They reflect, of course, substantial differences in underlying assumptions. For example, the OMB assumes average real growth of 4% annually, compared with the CBO's assumption of 3.1%. The OMB estimates inflation at 4% throughout this period, compared with the CBO's 4.8%. The Administration forecasts that Treasury bill yields will fall steadily to 5% by the end of 1989, while the CBO believes that these yields will average 9.7% in 1985 and then hold steady at 8.9% through 1989.

Figure 5. Differences Between Prospective and Actual Federal Budgets For One- to Five-Year Projections*, 1976-84 (Dollars in Billions)

	Current	1-Year	2-Year	3-Year	4-Year	5-Year
1984	$ 9.4	$ 14.5	$-91.4	$-206.3	$-255.9	$-280.8
1983	12.3	-103.9	-187.4	-219.9	-268.1	-271.6
1982	-12.0	-83.1	-115.4	-148.4	-155.8	-139.2
1981	-2.7	-42.1	-59.1	- 66.5	- 84.0	-133.4
1980	-19.8	-30.6	-22.1	- 73.0	-100.2	- 84.6
1979	9.7	32.9	-16.1	- 37.3	-28.1	
1978	13.0	-1.8	-16.0	- 29.2		
1977	12.2	-2.0	-14.4			
1976	9.6	-24.1				
Average	$ 3.5	$-26.7	$-65.2	$-111.5	$-148.7	$-181.9

*Overestimates are indicated with a plus (+); underestimates are indicated with a minus (-).

It is doubtful that either of these long-term projections will prove correct. Typically, economic expansions endure for three years and eight months and not for seven years. Inflation and interest rates tend to move up and certainly do not decline in the later stages of economic expansions.

Yet neither of these five-year projections includes the elimination of the budget deficit. For 1989, the OMB projects a deficit of $263 billion and the CBO a deficit of $139 billion. Indeed, the economic expansion required to virtually eliminate the deficit without changes in revenues and expenditures is far beyond our reach. Over the next five years, real growth would have to average about 5.8% yearly, and inflation would have to average 3.6%, as the unemployment rate falls to about 3.5% in 1989. Such a feat would be unprecedented. It would defy any historical comparisons. Today, we are on the threshold of the third year of expansion -- not the first. We are pushing against capacity constraints in some sectors, and the availability of skilled help is quite low.

Delaying significant deficit cuts is likely to result in much larger deficits in the future. A delay, as I noted earlier, will produce credit market clashes between the demands of the U.S. Treasury and those of the private sector. This will hamper the economic expansion before meaningful deficit reductions will have taken place. The result will be budget deficits of $250-350 billion, if a recession were to take place in 1986 or 1987. The five-year strategy will be shelved to deal with the cyclical economic hardships at hand.

What, then, is the alternative? I believe it is to reduce the budget deficit sharply -- by about $50-60 billion -- within the next 12 months. We are far more certain about economic prospects in this period than we are about conditions three to five years from now. For every year we delay, we run the risk of having deficit reductions coincide with, and reinforce, the next business recession. In this connection, a most timely opportunity was lost this year.

The salutary benefits of large budget reductions now would more than offset the risk that such a reduction in fiscal stimulus would push the economy into recession. Private sector credit demands would enjoy more room, as interest rates first decline and then rise (but not to new cyclical highs in key sectors). Inflation, too, would be dealt a significant blow. The markets would also recognize quickly that they are not hostage to a lasting structural budget deficit. In addition, the U.S. debt management task would be eased, and key sectors of the market, such as new housing activity and business capital formation, would benefit materially. Think of the positive market response if, after legislating deficit reductions of $60 billion, the Government would announce that it was reducing its gross new long-term bond financing to $10 billion from the current issuance of $36 billion per year.

A quick and substantial reduction of the deficit would go a long way toward limiting the interest expense on the debt.

This year, interest expense absorbed more than half of the deficit, and under current policies, interest costs will amount to three quarters of the deficit by the end of the decade. This reflects an insidious chain of self-reinforcing events in which large deficits raise interest costs, which in turn, create rising structural deficits. An important initial objective of the deficit reduction effort should be to balance the budget or create a surplus in the accounts net of interest expense. A deficit reduction of $60 billion next year, followed by a further cut of $25 billion in the subsequent year -- economic conditions permitting -- would achieve this objective.

The choices before Congress are difficult. Substantial deficit reductions in the next 12 months will require both a slowing in Federal outlays and new revenue-raising measures. A dependence primarily on new revenue-raising measures would be self-defeating. Because we are in an economic expansion, the private sector would initially cope with large tax increases by enlarging borrowings, not by limiting spending. This would aggravate, rather than ease, credit market conditions. I would suggest a deficit reduction package composed 40% of revenue-raising measures and 60% of expenditure reductions, with new taxes falling mainly on consumption. In the year following the inception of these measures, other initiatives to reduce the budget deficit should be considered, with the magnitude of this effort depending on current and near-term economic conditions.

In assessing the strategy for reducing the budget deficit, I see the following risks. A large deficit reduction within the next 12 months will, for a short time, temper the economic expansion. It will, however, encourage more balanced and longer economic growth, sharply reduce inflationary expectations, and prevent soaring interest rates at the cyclical peak of economic activity. If we wait until 1986 to undertake budget disciplining action, the recession tendencies that will be in the economic system by then will be reinforced. Adherence to a five-year plan, calling for modest deficit reductions in the early years and more noticeable results toward the close, would invite clashes between Government and private credit demands in the next few years, thus resulting in extreme financial strains and a subsequent business recession, in which the budget deficit will appear out of control.

Of these three strategies, the most demanding is for Congress to opt for large deficit reductions now. I believe, however, that such a strategy is the correct one.

Chairman Rostenkowski. Mr. Rohatyn, you may proceed.

STATEMENT OF FELIX G. ROHATYN, SENIOR PARTNER, LAZARD, FRERES & CO.

Mr. Rohatyn. Thank you, Mr. Chairman. I will read excerpts of my testimony.

It is always a pleasure and a privilege to give testimony to your committee. The issues you are concerned with today, namely taxes and the budget deficit, are probably the most important economic issues facing this country today. The manner in which the Congress and the administration deal with these issues will influence in an important way the economic and social evolution of this country between now and the end of the century.

The only certainty in economics is that economic forecasting is very uncertain. The policies you consider must recognize that reality.

The economy is presently growing strongly, inflation is low, unemployment is down. Whether this proves the success of supply side economics or is just another deficit-driven Keynesian recovery can be argued forever. What is important is to keep the recovery going and to deal with its weak spots. These weaknesses are the record domestic budget deficit and the record balance-of-trade deficit; the national debt headed for $2 trillion and the Third World debt headed for $1 trillion. Borrowing from our children to pay for our current expenses is neither moral nor prudent.

Can we grow our way out of these deficits? We don't seem to be doing so at a time when our economy has grown dramatically. The most important rule in business is never to bet the company. By betting everything on growth, we are running the risk of having our national debt overwhelm the Federal budget while preempting the capital requirements of our private sector.

The CBO has estimated that by 1989, the national debt will stand at 50 percent of GNP, up from 35 percent. Interest on the national debt will be over 20 percent of the budget and growing exponentially. That was the story of New York City between 1970 and 1975; that was Brazil and Mexico between 1975 and 1982. It must not be allowed to happen again.

The realities of the current situation do not permit any illusions. These realities include:

One, the budget and the national debt;

Two, the dollar and the international monetary system;

Three, the safety of our banking system and the international debt; and

Four, protectionism and international trade.

One way or another, all of these critical areas are related to our Federal budget deficit. Let us briefly look at them, one at a time.

The budget deficit is causing the national debt to grow at a rate almost three times the growth in GNP. That is a prescription for national bankruptcy, with interest on the national debt growing to over $200 billion per annum by the end of the decade, eating up more and more vital programs, like some kind of financial cancer. In addition to the obvious domestic costs being incurred, the level of risk in every area of financial weakness is consistently increased.

As a result of this escalation in indebtedness, the level of the dollar is constantly pushed upwards, with extremely negative results on American industries. Interest rates are maintained at very high levels, increasing the risk to our banking system of large-scale Third World debt problems. We are fostering speculation instead of investment. We are starving the rest of the world of badly needed captal and destabilizing the international monetary system. Since we live in a world market, whether we like it or not, we cannot continue this much longer.

Eventually, we will be forced to do something about the deficit. The question is what to do and when. The answer to "when" is easy: no later than early 1985 and, before the next economic downturn. Having to close the budget gap in a recessionary environment would involve extremely high levels of risk. The question of "how" and at what velocity is more difficult.

It seems to me that, with the economy as strong as it is now, a program to close the gap by about $150 billion over 3 years made up roughly 50 percent by taxes and 50 percent by cuts is not unreasonable. The CBO projects a deficit of about $216 billion for fiscal year 1987. This approach would leave about $60 billion of deficits, which in itself is quite sustainable as a percent of GNP, and lower interest rates should eliminate much of that balance.

Higher taxes are not a recipe for economic growth; on the contrary. Simply taxing the rich will not make the poor affluent; that is a basic reality. If taxes are increased, it should be done in a way least likely to slow down the economy. It should also be combined with a simplification of the tax system which results in lower personal rates and less deductions and loopholes.

Tax increases in my judgment should be two-fold. They should be based on consumption (thereby encouraging savings) and a minimum tax should be imposed on corporations which are, in many cases, paying little or no taxes at all. In 1975, corporate taxes made up 15.6 percent of Federal revenues; in 1983, they were 6.2 percent.

Bradley-Gephardt, or some variation thereof, should be the main vehicle on personal taxes. A maximum personal income tax rate at 28 to 30 percent, with a minimum of deductions seems to be very sound. A minimum corporate income tax somewhere between 15 to 20 percent—depending on the definition of corporate income—seems to be equally sound. Indexation is a necessary brake on spending when marginal rates are at 50 percent.

Indexation can be eliminated in exchange for a maximum personal income tax rate below 30 percent. I believe that Bradley-Gephardt is intended to be essentially neutral in terms of revenue raising. However, combined with the elimination of indexing and a minimum corporate income tax, it should be skewed to raise about $20 billion by the third year.

Energy, in my judgment, should be the main source of consumption tax increases through a mix of crude oil excise taxes and oil import fees. The energy taxes should raise about $40 billion—$50 billion annually; phased in over 3 years. I don't believe they would not hurt the economy. A portion of these taxes would undoubtedly be translated into higher gasoline prices. However, gasoline prices in Europe are $2.50 to $3 per gallon; here, such a tax would still leave gas prices at 50 percent of European prices.

I believe that investment, as opposed to speculation, should be encouraged by changes in the capital gains tax holding period. Taxes should go up as the holding period goes down and vice versa. Tax-exempt institutions such as pensions funds, should be taxed on security transactions with short holding periods. These institutions are supposed to be long-term investors; they have occasionally turned into short-swing speculators. When they do, they should pay the price.

The critical question with any tax increase is whether the revenue raised will simply be translated into new spending or whether it will genuinely be used to reduce the deficit. The only way to assure the latter is to dedicate the tax to nonspending purposes. One way to do so would be to create a trust fund into which all new energy taxes would be paid. The trust fund would be managed by the Federal Reserve bank which would use the proceeds solely for the purpose of retiring a person of the Federal debt.

In order to make this arrangement an effective deterrent to spending, two additional features should be attached:

First, it should be combined with a limitation on the growth of the Federal debt to a fixed percent of the GNP; and

Second, it should provide for the tax to increase automatically by the amount that the debt limit is raised, in any one year, beyond those limits.

These provisions would insure that the ability to borrow would be sharply curtailed and combined with an offsetting tax penalty. It would then alleviate the pressure on the financial markets by reducing the need for Government financing and it would ease the upward pressure on interest rates. It could allow the Fed to run an easier monetary policy without risk on inflation.

A variation of this type of arrangement was used when New York City sales taxes were segregated out of the expense budget to guarantee debt service on municipal assistance corporate bonds. I believe that segregating a new source of revenue for the sole purpose of reducing the size of the national debt is worthy of serious study. It will not relieve anyone of the need to control the growth in expenditures; on the contrary. However, if deficits are inevitable due to the nature of our political system, such a mechanism could create an easier interest-rate environment and offset somewhat our low national savings rate. It is, in essence, a form of national savings plan.

I do not offer this suggestion as a panacea, but I am most skeptical about our capacity to control the Federal budget. As a second best alternative, this suggestion would, at least, slow the growth of the national debt.

I do not favor constitutional changes to solve this problem. A constitutional amendment to balance the budget is somewhat like a nuclear freeze: it gives the illusion of safety without any reality behind it.

Coming now to the budget. "To amass military power without regard to our economic capacity would be to defend ourselves against one kind of disaster by inviting another." I am quoting from a speech by President Eisenhower early in 1953.

I am not a military expert, but I am familiar with large corporate organizations, and I know how to read and how to count. There is no question in my mind that the military budget, like that of any huge organization, can be cut substantially without affecting our military capabilities. You have your own experts who can make credible cases for multibillion dollar annual savings in the weapons system side of the military budget. Additional savings should come out of a reform of military pensions and other personnel costs. An annual rate of savings of $20 billion to $25 billion, translated into slower growth of the military budget, must be achieved.

Coming now to social programs, now one can credibly talk about reducing the budget deficit without discussing entitlements. The fair capping of entitlement growth may be the most important social issue facing this country. Medical technology is exploding. The resulting increase in life expectancy is going to be dramatic, in my judgment. What this will do, not only to social costs, but to the agonizing choices literally of life maintenance or death, is only dimly perceived at this time.

Significant changes and savings are obviously necessary. A detailed program of cost-containment has to be spelled out. Means-testing will probably have to be part of any program; taxing some benefits; capping COLA's, changing benefits for new entrants. This is all very painful, and at this time may be impossible politically. However, if deficit reduction is to become a reality, one cannot avoid this area and remain credible. One cannot maintain the fiction that the budget can be balanced by tax increases and military cuts alone.

In view of the complexity of these budget cuts and the urgency of the problem, you may wish to consider a 1-year expenditure freeze on all spending programs while a tax package is put in place. This would save about $40 billion in the first year and may well be the most practical approach for the time being.

I strongly support Senator Dole's recommendation for a bipartisan economic summit immediately after the election. Not only the political window of opportunity, but the financial window of opportunity may be close if we wait until the next recession.

By most standards—purchasing power, relative levels of inflation, et cetera—the dollar is overvalued by 25 percent to 30 percent vis-a-vis the major European currencies and the yen. The result is a disaster on our balance of trade, a disaster for many domestic industries and enormous protectionist pressures. The level of the dollar is partly due to our high interest rates, partly due to the fact that we are forced to borrow abroad, and partly due to the attractiveness of the U.S. markets as political and economic havens for capital. It has been a boon to Japanese and European exporters, has helped to keep domestic inflation down, and has been exceedingly harmful to Third World borrowers and nonindustrialized countries.

An orderly, gradual reduction in the value of the dollar, as a result of responsible budget actions is highly desirable, a precipitous decline, as a result of large capital outflows, would create serious problems. In the present state of the world, the dollar will always command a premium for political reasons, there is no need to superimpose a surcharge because of our budget problems.

It is likely that credible budget-closing actions by the United States, with their resulting interest rate reductions, will help reduce the overvaluation of the dollar. Equally important, however, is the recreation and maintenance of an orderly international monetary system.

Although it is impossible to go back to a fixed-rate system, there are good grounds to study a system where the main currencies would only be allowed to fluctuate within certain limits by coordination among the central banks.

This is an exceedingly complicated but nonetheless vital subject. Only the United States can take the lead in dealing with this situation, but the United States can only do so by, first, taking serious actions to put its own financial house in order.

Many factors were responsible for the presently dangerous overextension of the U.S. banking system. About $700 billion of worldwide debt is owed Western banks, about $350 billion in Latin America alone, about $100 billion of that amount to U.S. banks. It is worth noting that the capital of all U.S. banks is probably less than $100 billion.

Despite the current feeling that the crisis is over, the problem will not go away. There is no solution to this problem, but a long process of adjustment is clearly needed in which the U.S. Government plays an active role. The objective must be twofold:

To protect the U.S. banking system and to maintain our banks in a position to finance our economic growth; and second, to adjust interest and maturities of the debt to the social and economic capacity of the borrowers to pay.

Lower interest rates, worldwide, as a result of U.S. budgetary actions, will significantly assist both of these objectives.

After the election, the United States should take the lead in developing a plan by the Fed and the U.S. Treasury, together with the IMF and the banks, which will provide longer and easier repayment terms for the Latin American borrowers.

Last, international trade and protectionism. As long as the international monetary system remains chaotic and the dollar overvalued, there will be enormous strains and demands for protection as one country after another looks after its interests. Since most of our trading partners practice some type of explicit or implicit industrial policies which include Government assistance, we have to be ready to respond rationally.

In testimony which I gave to the International Trade Commission, I urged an industrial policy relating to steel which would give temporary protection in exchange for explicit commitments by the industry to modernize. These commitments would include management commitments for new investments in modern facilities as well as funds for displaced workers, together with union commitments for wage restraint, profit-sharing arrangements and productivity improvements. The ITC, in announcing its decision to recommend quotas to the President, specifically recommended the principle of conditionality as part of the package. This is the essence of industrial policy.

If, as a result of timely budget actions, the value of the dollar is reduced, the need for quotas or tariffs would obviously be reduced. The duration of the protection could then be significantly shortened.

Protectionism is destructive. Allowing our basic industries to be destroyed because of an overvalued currency is suicidal. Both can be avoided if interest rates and the value of the dollar are brought down as a result of fiscal responsibility.

The current strength of our economy, coupled with the low rate of inflation, provide a spectacular opportunity to ensure long-term growth for our economy. If the issues I have briefly discussed are dealt with on a timely basis, the American economy could respond strongly and steadily for the long term. However, if we wait for the next recession before we act, we could be faced with higher deficits, higher interest rates, a collapsing dollar and our banking system under great pressure. The policy choices facing you at that time will make the current ones look easy. I have rarely seen a risk-reward ratio that was so sharply tilted to strong and early action.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF FELIX G. ROHATYN, SENIOR PARTNER, LAZARD, FRERES & CO.

Mr. Chairman; Members of the Committee.

As always, it is a pleasure and a privilege to give testimony to your Committee. The issues you are concerned with today, namely taxes and the budget deficit, are probably the most important economic issues facing this Country today. The manner in which the Congress and the Administration deal with these issues will influence in an important way, the economic and social evolution of this Country between now and the end of the century.

I am an investment banker whose business it is to provide financial advice to large U.S. and foreign corporations. I am also Chairman of New York's Municipal Assistance Corporation. It may interest you to know that since New York City' financial crisis in 1975, MAC has raised over $9 billion for New York City and that the City has just completed its fourth successive year with a budget surplus. We have shown that fiscal discipline is both possible and profitable. My perspective bridges, therefore, both private sector, as well as public sector finance.

The only certainty in economics is that economic forecasting is very uncertain. The policies you consider must recognize that reality. Their objective should be to reduce the risk of significant economic and financial dislocation in the future, and to show a maximum of fairness and common sense in their application.

The economy is presently growing strongly, inflation is low, unemployment is down. Whether this proves the success of supply-side economics or is just another deficit-driven Kenynesian recovery can be argued forever. What is important is to keep the recovery going and to deal with its weak spots. These weaknesses are the record domestic budget deficit and the record balance-of-trade deficit; the national debt headed for $2 trillion and the Third World Debt headed for $1 trillion. Borrowing from our children to pay for our current expenses is neither moral nor prudent.

Can we grow our way out of these deficits? We don't seem to be doing so at a time when our economy has grown dramatically. The most important rule in business is never to bet the company. By betting everything on growth, we are running the risk of having our national debt overwhelm the federal budget while preemptingthe capital requirements of our private sector. The CBO has estimated that by 1989, the national debt will stand at 50% of GNP, up from 35% in 1983. Interest on the national debt will be over 20% of the budget and growing exponentially. That is the story of New York City between 1970 and 1975; that is Brazil and Mexico between 1975 and 1982. It must not be allowed to happen here.

Fairness is a term which is in considerable use these days, but which seems to mean different things to different people. In dealing with our budget problems, we cannot create the illusion that fairness means that the government will simply do more for the poor, the unemployed, the retired, the minorities, etc. Fairness means that the largest sacrifices must be made by those who can afford them but that, unfortunately, everybody will have to sacrifice. This was the principle we tried to follow in the resolution of New York City's fiscal crisis. It should be the basis for the resolution of the national budget and debt crisis, both as it pertains to taxes as well as to entitlement programs. The realities of the current situation do not permit any illusions. These realities include:

1) the budget and the national debt;
2) The dollar and the International Monetary System;
3) The safety of our banking system and the International Debt;
4) Protectionism and International trade;

One way or another, all of these critical areas are related to our federal budget deficit. Let us briefly look at them, one at a time:

1) The Budget and the National Debt. The budget deficit is causing the national debt to grow at a rate almost three times the growth in GNP. That is a prescription for national bankruptcy, with interest on the national debt growing to over $200 billion per annum by the end of the decade, eating up more and more vital programs, like some kind of financial cancer. In addition to the obvious domestic costs being incurred, the level of risk in every area of financial weakness is consistently increased. As a result of this escalation in indebtedness, the level of the dollar is constantly pushed upwards, with extremely negative results on American industries. Interest rates are maintained at very high levels, increasing the risk to our banking system of large-scale Third World debt problems. We are fostering speculation instead of investment; spending instead of saving. We are purchasing short-term prosperity by starving the rest of the world of badly needed capital and destabilizing the international monetary system. Since we live in a world market, whether we like it or not, we cannot continue this much longer

Eventually, we will be forced to do something about the deficit. The question is: what to do and when. The answer to "when" is easy: no later than early 1985 and, before the next economic downturn. Having to close the budget gap in a recessionary environment would involve extremely high levels of risk. The question of "how" and at what velocity is more difficult.

It seems to me that, with the economy as strong as it is now, a program to close the gap by about $150 billion over three years made up roughly 50% by taxes and 50% by cuts is not unreasonable. The CBO projects a deficit of about $216 billion for fiscal 1987. This approach would leave about $60 billion of deficits, which in itself is quite sustainable as a % of GNP, and lower interest rates should eliminate much of that balance.

1) Taxes. Higher taxes are not a recipe for economic growth; on the contrary. Simply taxing the rich will not make the poor affluent; that is a basic reality. If taxes are increased, it shouldbe done in a way least likely to slow down the economy. It should also be combined with a simplification of the tax system which results in lower personal rates and less deductions and loopholes

Tax increases should be twofold. They should be based on consumption (thereby encouraging savings) and a minimum tax should be imposed on corporations which are, in many cases, paying little or no taxes at all. (In 1975, corporate taxes made up 15.6% of federal revenues; in 1983, they were 6.2%).

Bradley-Gephardt, or some variation thereof, should be the main vehicle on personal taxes. A maximum personal income tax rate at 28%-30%, with a minimum of deductions seems to me very sound. A minimum corporate income tax somewhere between 15-20% (depending on the definition of corporate income) seems to me equally sound. Indexation is a necessary brake on spending when marginal rates are at 50%. Indexation can be elimated in exchange for a maximum personal income tax rate below 30%. I believe that Bradley-Gephardt is intended to be essentially neutral in terms of revenue raising. However, combined with the elimination of indexing and a minimum corporate income tax, it should be skewed to raise about $20 billion by the third year.

Energy should be the main source of consumption tax increases through a mix of crude oil excise taxes and oil import fees. The energy taxes should raise about $40 billion - $50 billion annually; phased in over three years they would not hurt the economy. A portion of these taxes would undoubtedly be translated into higher gasoline prices. However, gasoline prices in Europe are $2.50 to $3.00 per gallon; here, such a tax would still leave gas prices at 50% of European prices. It would encourage conservation, energy independence, the purchase of small cars instead of the current trend to big ones.

I believe that investment, as opposed to speculation, should be encouraged by changes in the capital gains tax holding period. Taxes should go up as the holding period goes down and vice versa. Tax-exempt institutions such as pension funds, should be taxed on security transactions with short holding periods. These institutions are supposed to be long-term investors; they have occasionally turned into short-swing speculators. When they do, they should pay the price.

Segregating the tax

The critical question with any tax increase is whether the revenue raised will simply be translated into new spending or whether it will genuinely be used to reduce the deficit. The only way to assure the latter is to dedicate the tax to non-spending purposes. One way to do so would be to create a Trust Fund into which all new energy taxes would be paid. The Trust Fund would be managed by the Federal Reserve Bank which would use the proceeds solely for the purpose of retiring a portion of the Federal Debt.

In order to make this arrangement an effective deterrent to spending, two additional features should be attached:

a) It should be combined with a limitation on the growth of the Federal debt to a fixed % of the GNP; and

b) It should provide for the tax to increase automatically by the amount that the debt limit is raised, in any one year, beyond those limits.

These provisions would insure that the ability to borrow would be sharply curtailed and combined with an offsetting tax penalty. It would then alleviate the pressure on the financial markets by reducing the need for government financing and it would ease the upward pressure on interest rates. It could allow the Fed to run an easier monetary policy without risk of inflation

A variation of this type of arrangement was used when New York City sales taxes were segregated out of the expense budget to guarantee debt service on MAC bonds. I believe that segregating a new source of revenue for the sole purpose of reducing the size of the national debt is worthy of serious study. It will not relieve anyone of the need to control the growth in expenditures; on the contrary. However, if deficits are inevitable due to the nature of our political system, such a mechanism could create an easier interest-rate environment and offset somewhat our low national savings rate. It is, in essence, a form of national savings plan.

I do not offer this suggestion as a panacea, but I am most skeptical about our capacity to control the Federal budget. As a second best alternative, this suggestion would, at least , slow the growth of the national debt.

I do not favor constitutional changes to solve this problem. A constitutional amendment to balance the budget is somewhat like a nuclear freeze: it gives the illusion of safety without any reality behind it.

2) Budget Cuts

a) Military

"To amass military power without regard to our economic capacity would be to defend ourselves against one kind of disaster by inviting another". I am quoting from a speech by President Eisenhower early in 1953.

I am not a military expert, but I am familiar with large corporate organizations, and I know how to read and how to count. There is no question in my mind that the military budget, like that of any huge organization, can be cut substantially without affecting our military capabilities. You have your own experts who can make a credible case for multibillion annual savings in the weapons systems side of the military budget. Additional savings should come out of a reform of military pensions and other personnel costs. An annual rate of savings of $20-25billion, translated into slower growth of the military budget, must be achieved.

b) Social Programs. No one can credibly talk about reducing the budget deficit without discussing entitlements. The fair capping of entitlement growth (Social Security, Medicare, Medicaid, etc.) may be the most important social issue facing this Country. Medical technology (pharmaceutical and DNA research, operating room techniques & equipment, diagnostics techniques, etc.) is exploding; the resulting increase in life expectancy is going to be dramatic, in my judgement. What this will do, not only to social costs, but to the agonizing choices literally of life maintenance or death, is only dimly perceived at this time. Significant changes and savings are obviously necessary. A detailed program of cost-containment has to be spelled out. Means-testing will probably have to be part of any program; taxing some benefits; capping COLA's, changing benefits for new entrants, etc. This is all very painful, and at this time may be impossible politically. However, if deficit-reduction is to become a reality, one cannot avoid this area and remain credible. One cannot maintain the fiction that the budget can be balanced by tax increases and military cuts only.

c) Freeze

In view of the complexity of these budget cuts and the urgency of the problem, you may wish to consider a one year expenditure freeze on all spending programs while a tax package is put in place. This would save about $40 billion in the first year and may well be the most practical approach for the time being.

I strongly support Senator Dole's recommendation for a bipartisan economic "Summit", immediately after the election, to deal with the budget. Not only the "political window of opportunity", but the "financial window of opportunity" may close if we wait until the next recession looms. It will be too late then

2) The Dollar and the International Monetary System

By most standards (purchasing power, relative levels of inflation, etc.), the Dollar is overvalued by 25%-30% vis-a-vis the major European currencies and the Yen. The result is a disaster on our balance-of-trade, a disaster for many domestic industries and enormous protectionist pressures. The level of the Dollar is partly due to our high interest rates, partly due to the fact that we are forced to borrow abroad, and partly due to the attractiveness of the U.S. markets as political and economic havens for capital. It has been a boon to Japanese and European exporters, has helped to keep domestic inflation down by keeping commodity prices down, and has been exceedingly harmful to Third World borrowers and non-industrialized countries.

An orderly, gradual reduction in the value of the Dollar, as a result of responsible budget actions is highly desirable; a precipitous decline, as a result of large capital outflows, would create serious problems. In the present state of the world, the Dollar will always command a premium for political reasons; there is no need to superimpose a surcharge because of our budget problems.

It is likely that credible budget-closing actions by the U.S., with their resulting interest rate reductions, will help reduce the over-valuation of the dollar. Equally important, however, is the recreation and maintenance of an orderly international monetary system. The dramatic gyrations of foreign exchange rates, the explosion in world indebtedness, the speculative tides of money which have occured in the last twelve years have had a major destabilizing effect on world trade, the economies of many countries, and as a result, the political stability of a larger part of the world. Although it is impossible to go back to a fixed-rate system, there are good grounds to study a system where the main currencies would only be allowed to fluctuate within certain limits by coordination among the central banks and finance ministries.

This is an exceedingly complicated, but nonetheless vital subject. Only the U.S. can take the lead in dealing with this situation, but the U.S. can only do so by, first, taking serious actions to put its own financial house in order.

3) The Banking System and International Debt

Many factors were responsible for the presently dangerous overextension of the U.S. banking system. Petrodollar recycling and the creation of a trillion dollar unregulated Eurodollar market in the 1970s; deregulation of financial institutions coupled with overagressive lending and lax oversight in the U.S.; carelesss borrowing by overseas borrowers; all were involved in what is finally recognized as a dangerous situation. About $700 billion of world-wide debt is owed to Western banks, about $350 billion in Latin America alone, about $100 billion of that amount to U.S. banks. A number of our largest banks have lent over 100% of their capital to Brazil, Argentina and Mexico which have a combined debt of $230 billion. It is worth nothing that the capital of all U.S. banks is probably less than $100 billion.

Despite the current feeling that the crisis is over, the problem will not go away. There is no "solution" to this problem, but a long process of adjustment is clearly needed in which the U.S. Government plays an active role. The objective must be twofold:

1) To protect the U.S. banking system and to maintain our banks in a position to finance our economic growth;

2) To adjust interest and maturities of the debt to the social and economic capacity of the borrowers to pay, under continued but modified IMF supervision.

Lower interest rates, world-wide, as a result of U.S. budgetary actions, will significantly assist both of these objectives. To the argument that the government must not interefere with the market system, the answer is that we are doing it now. In rescuing the Continental Illinois Bank from bankruptcy, we are actually in the process of nationalizing one of the ten largest banks in the country. The current rescue package from the FDIC has already provided $5 billion and will undoubtedly go higher, and the FDIC will ultimately own 80% or more of the bank.

The FDIC and the Fed have unconditionally guaranteed all of the deposits, all of the general creditors and total liquity. The Continental Illinois was a $40 billion bank and these government commitments go far beyond anything we have seen since 1932.

Although there is no question in my mind that the bank could not be allowed to fail, the sweeping nature of the U.S. government commitments has yet to be carefully analyzed and understood. It is safe to conclude that, based on the precedent of the of the Continental Illinois, the U.S. government has unconditionally guaranteed, at the very least, all the depositors (not just those upto $100,000), and possibly, all the general creditors and the liquidity of all major U.S. banks. This could be a trillion dollar commitment or more.

After the election, the U.S. should take the lead in developing a plan by the FED and the U.S. Treasury, together with the IMF and the banks, which will provide longer and easier repayment terms for the Latin American borrowers. It should be conditioned on continued fiscal discipline on the part of the borrowers, and having open and safe markets for our capital. Such a plan should protect the banks' viability while requiring more capital and more conservative accounting to protect both depositors and investors.

Since we have put the credit of the U.S. behind our large banks, we must use this leverage to defuse a situation which could destabilize not only the banks, but all of Latin America, if allowed to continue unchecked.

4) International Trade and Protectionism

As long as the international monetary system remains chaotic and the dollar overvalued, there will be enormous strains and demands for protection as one country after another looks after its interests. Since most of our trading partners practice some type of explicit or implicit industrial policies which include government assistance, we have to be ready to respond rationally.

In testimony which I gave to the International Trade Commission on May 21, 1984, at the request of Bethlehem Steel Corporation and the United Steelworkers, I urged an industrial policy relating to steel which would give temporary protection in exchange for explicit commitments by the industry to modernize. These commitments would include management commitments for new investments in modern facilities as well as funds for displaced workers, together with union commitments for wage restraint, profit-sharing arrangements and productivity improvements. The ITC, in announcing its decision to recommend quotas to the

President, specifically recommended the principle of conditionality as part of the package. This is the essence of industrial policy.

The issue of automobile quotas with Japan is coming up again and these should form part of a similar package with the auto industry and the UAW.

If, as a result of timely budget actions, the value of the dollar is reduced, the need for quotas or tariffs would obviously be reduced. The duration of the protection could then be significantly shortened.

Protectionism is destructive. Allowing our basic industries to be destroyed because of an overvalued currency is suicidal. Both can be avoided if interest rates and the value of the dollar are brought down as a result of fiscal responsibility.

The current strength of our economy, coupled with the low rate of inflation, provide a spectacular opportunity to ensure long-term growth for our economy. If the issues I have briefly discussed are dealt with on a timely basis, the American economy could respond strongly and steadily for the long-term. However, if we wait for the next recession before we act, we could be faced with higher deficits, higher interest rates, a collapsing dollar and our banking system under great pressure. The policy choices facing you at that time will make the current ones look easy. I have rarely seen a risk-reward ratio that was so sharply tilted to strong and early action.

Chairman **Rostenkowski**. Thank you, Mr. Rohatyn.

Once again I would like to express my personal gratitude. In personal conversations with both of you, I have asked you to appear before this committee to give us an overview of what problems in the future this committee should be looking at. I want to congratulate you on your presentations. You both have made indepth observations that are most worthwhile. I do not know whether you are aware, but we expect this committee to be together over the weekend on a "tax retreat" to talk about the deficit, tax restructuring and this committee's role in developing responsible solutions.

The deficit is something that we all talk about. However, I do not know whether the American public understands how much of a problem it is for this country. Certainly when interest rates rise, then the Earth shakes, and the public will recognize that the deficits must be addressed.

In my opinion, the Committee on Ways and Means or the Senate Finance Committee could work 24 hours a day, 7 days a week on this problem. However, if we intend to be serious next year—and I hope it is 1985 that we roll up our sleeves and do something about the deficit—there is no way in the world in my opinion that we can proceed without the assistance of the President. I do not care who sits in that office. After the second Tuesday in November, there must be a concentrated effort on all our parts to work this through.

We have tried over the last several years to provide leadership. We have tried, on a bipartisan basis, to act responsibly on a very small initiative with respect to revenue raising and the curtailment of social spending. However, it is very difficult for us to do that without the total commitment from everyone who should be involved in this. So as chairman of the committee, I want you both to know that I sincerely appreciate your taking time to join in this discussion. I think that your presence here highlights the seriousness of the problem which this committee must address in the next 18 or 19 months.

Mr. Rangel will inquire.

Mr. **Rangel**. I want to join with the chairman. Your testimony has been very helpful. I do hope that both of you would be available as the committee starts to deliberate. We need your expertise and your guidance.

Mr. Rohatyn, as a fellow New Yorker, I have to thank you for giving so liberally of your time in order to help us. I just have one question to you and that is, you talk a great deal about the consumption tax and the energy tax and it is so inconsistent in my opinion with your sense of fairness and equity in terms of everyone making the sacrifice and not just the lower income people and the consumption tax to me really causes the person with a limited income to sacrifice and the people above a certain income not to have to make that sacrifice. It seemed a little inconsistent with your economic theories, which I thoroughly support.

Mr. **Rohatyn**. I appreciate that concern. I also proposed a minimum corporate income tax which I think goes to the issue of fairness. I proposed changes in the personal income tax structure to eliminate a lot of deductions which I think make it a lot easier for people in my brackets not to pay taxes than for people in lower brackets. You can't do this without people getting hurt somewhere.

I believe that consumption taxes philosophically in a proper mix with income taxes have their place as long as you are careful in how you do it.

I have always believed that energy and gasoline, which we are so profligate with in this country and which are so cheap, are the least painful way of doing it. I wouldn't support a VAT or a national sales tax because of that. I think that people can control the amount of gasoline taxes they pay. They can control it by driving slower. They can control it by carpooling. They can control it by buying different types of cars. And although I recognize the question you raise, I believe that of the options that I have looked at, and none of them involve an alternative where on the one hand you have pain and on the other you have pleasure, but where you only have alternatives of pain or a little more pain, I believe that at least this structure would leave me less uncomfortable on the issue of fairness than a lot of others.

Chairman **Rostenkowski**. Mr. Conable will inquire.

Mr. **Conable**. I would like to talk to Mr. Kaufman for a minute.

Mr. Kaufman, is it possible to quantify what would happen to interest rates were we to shut off access to the Eurodollar market? I admit we have had limited access in the past, but we have had access for major corporate issues.

I acknowledge that there always is an enforcement compliance problem. But it is suggested that that is so grave that we should deny our access to a major source of capital.

I am sure you did not intend any implication when you said that interest rates would have to be high to keep from a flight of foreign capital from this country, as the economy matures further.

I didn't suggest any implication there that you thought that it was desirable not to borrow from abroad. And I wonder if you could discuss that issue with us, because quite frankly, there is a good deal of pressure at this point to try to reduce the access which already, at least with respect to Treasury bonds, I think is on the edge of no access at all, given the registration requirements that we have.

Treasury has been to some degree "sicklied o'er with a pale cast of thought" on this issue, and has tried to find some kind of a middle ground. But I personally am concerned about the loss of access, what it might do to interest rates, and that is why I am asking you this question in so many ways here.

If you would comment on it, I would appreciate it.

Mr. **Kaufman**. No. I have never advocated that we should cut off access to the Euromarket, because American corporations, as you know, borrow abroad, American banks borrow from their branches abroad.

In fact, this year, American banks have borrowed from their branches abroad and re-lent their funds within the United States. American corporations are borrowing abroad and using that money globally, both in the United States as well as elsewhere.

I would not advocate cutting off the Eurodollar market.

However, having said that, there is the issue of the U.S. Government moving directly into the markets abroad as an aggressive demander of money.

And I do think under current circumstances, aggressive merchandising of U.S. Treasury obligations abroad can induce foreigners to put more money into the U.S. dollar, and in that sense, aggravate the value of the dollar in the foreign exchange market and put it to even higher levels, an undesirable aspect certainly, to say the least.

Having said that, I would also suggest that there ought to be not a shut-off of the Eurodollar market, but eventually a better surveillance of the Eurodollar market than we have had up to date. It seems to me that financial institutions participate in this market under different regulations and under different rules.

Our capital requirements for commercial banks here are one thing, capital requirements of other banks abroad are different from ours.

We all have different rules and regulations, but operate in the same market.

It would be far more salutary in the future if there would be somewhat more uniform regulations in surveillance of this market than we have at the present time. But I would not advocate——

Mr. **Conable**. I am certainly not saying we shouldn't have surveillance of it. But the issue of access is important in terms of interest rate levels in this country, is it not?

Mr. **Kaufman**. Yes. The issue of access is important for American corporations who borrow abroad, and financial institutions borrow abroad.

At the same time, there are a variety of international borrowers that are very active in the Eurodollar market. I don't advocate closing down that market. I think it would be wrong.

But I think the rules and regulations for that market ought to be improved, and I think our Government should be very circumspect about initiating aggressive merchandising measures of U.S. Government securities abroad at a time when the dollar is very strong.

Mr. **Conable**. Mr. Rohatyn wants to say something.

Mr. **Rohatyn**. I would like to comment on that. I think that is a very important question. I strongly support what Henry says about limiting the use of foreign markets for U.S. Government borrowing, especially when the dollar is at these levels.

But second, as a kind of a philosophical question, the one thing that I learned in the experience we had in New York City's financial problems was that the only time the city faced up to its budget problems was when it had restricted market access or no market access.

And I would be inclined to make access—I would not be inclined to make it easier for the U.S. Government to finance abroad, because I think to——

Mr. **Conable**. Isn't that a little like saying that the way to control the spending is to have a big deficit?

Mr. **Rohatyn**. No. I think the way to control the deficit is to have less ability to borrow. Because then you are going to have to do it.

Mr. **Conable**. How do you know we won't just raise taxes?

Mr. **Rohatyn**. Well, but you will reduce the deficit, then. How you reduce it is another issue.

Mr. **Conable**. I think it is another issue.

Mr. **Rohatyn**. I understand that. But I think since it is also easier to borrow, even by driving up interest rates, and driving the foreign exchange structure to really dangerous levels, I would urge you to limit the temptation of borrowing in the foreign markets for the U.S. Government, because I think that is an unhealthy thing.

Mr. **Conable**. Well, I think you are optimistic if you think the effect of that might not just be to have the domestic market have to carry a much greater burden, also.

Mr. **Rohatyn**. Well, I would think that the immediate impact on interest rates created by problems for the Government financing will make people understand much more graphically that there is a real problem here than if we keep on with this luxury of keeping our interest rates relatively down by pushing the dollar up, by borrowing abroad.

Mr. **Conable**. Do you think the Government would have to pay more interest on its national debt, the theory being somehow that would discipline us here in Congress?

Mr. **Rohatyn**. I think that we are being subsidized in terms of our interest rates in this country by the luxury that we have of borrowing abroad. And I think that is a luxury——

Mr. **Conable**. Why isn't that just as much a luxury then for corporations as it is for Government?

Mr. **Rohatyn**. Because corporations have a budget balancing discipline, that is entitled cash flow and bankruptcy, that we don't have in Government.

Mr. **Conable**. I don't want to carry that any further. I think you are being very open, sir, if you think by lifting the Government's access to the foreign money we can somehow greatly improve our practices overall.

I am interested in your viewpoint. Thank you.

Chairman **Rostenkowski**. Mr. Heftel will inquire.

Mr. **Heftel**. Thank you, Mr. Chairman.

I think the dilemma of this committee as portrayed by the chairman has been heightened by the presence of both of you gentlemen who have very simply and accurately portrayed the answers that we should be implementing.

But unfortunately, we seem to have a system that is incapable of implementing those answers. The best answer that the administration has come up with, however, is a balanced budget amendment to the Constitution.

I wonder if you would quickly respond to that concept in terms of whether you think it has any merit.

Mr. **Kaufman**. Well, I really believe that economic morality cannot be legislated. If it could be legislated, in a sense, when Moses came down from Mt. Sinai, we had Ten Commandments, and if we had adhered to all of them all the time, some problems would not have come to pass.

It seems to me we have a complex economic and financial system that requires flexibility in both revenues and in expenditures in order for us to respond to changing conditions.

Second, a balanced budget amendment means that we are going to balance the budget. Now, this is supposed to be an adult society. We are all supposed to be responsible. And I cannot see why we cannot act in a responsible and orderly fashion without that kind of legislation.

I would assume there are balanced budget amendments and there are balanced budget amendments. I do not see how such an amendment is going to be adhered to as we go through an economic cycle of economic expansion, or a cycle of economic contraction, because the budgetary requirements vary under those conditions.

And from that viewpoint, in managing the economy, I would be opposed to a balanced budget amendment.

Mr. **Rohatyn**. I share that view very much. I said in my testimony that I thought that a balanced budget amendment was like an uncontrolled nuclear freeze, where everybody has the illusion of having done something, but nothing has really happened.

You don't need a balanced budget amendment in this country. All you need to do is to take common sense, rational budget actions, relatively—in a relatively timely fashion.

I would think a balanced budget constitutional amendment or the need to go to one would be such an abdication of the notion that a democracy can handle its own problems, that I would hate to see it happen.

Second, I don't think it would work. And third, I think you would be creating jobs for another 8 million accountants in figuring out ways to go around it, which would not be all that difficult.

Mr. **Heftel**. Thank you, gentlemen.

I thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Pease will inquire.

Mr. **Pease**. Thank you very much, Mr. Chairman.

I was intrigued by the line of questioning that I had with Mr. Penner about what would happen if another recession came along, and what would be the appropriate response.

I would like to ask you two gentlemen to comment on the following theoretical scenario. Suppose a year from now it is clear that we are in a recession that would start, say, in the summer of 1985, so that by September or October, it is clear that without any changes in policy, Government spending will increase as a result of unemployment and public assistance costs and so on, and Federal revenue will decrease as people are unemployed and unable to pay taxes. Consequently, the deficit will rise sharply beyond that already projected.

I am interested in knowing what each of you would think would be the correct Federal policy response to this scenario. I see three possible alternatives—one would be to maintian the status quo in terms of economic policy, including no additional spending through pump priming and no tax increases.

A second alternative would be to further increase the deficit by passing public works and extended unemployment compensation bills and so on, and to combine these actions with a reduction in taxes—in other words, the traditional Keynesian approach to a recession.

The third alternative to stem the growth of the deficit at that time—I presume there would be no hope to actually reduce the deficit—would be to try to restrain any increase in the deficit by raising taxes and cutting spending, as both of you have suggested this morning, assuming normal circumstances.

Which of these three alternatives, or some variation of them, do you think would be the correct policy if we were to have a recession a year from now?

Mr. KAUFMAN. If we move into a recession, I would be against raising taxes and raising revenues at that point in time. I think under those conditions, we should have a minimum of increases in spending that is required and mandated under law for the social programs, and therefore, rely for restimulating the economy much more on monetary policy than we did the last time around.

Additionally, in that period of economic slowdown, I think Congress should again look at what the revenue and expenditure profile would be in the first and second year of recovery, and begin to program in a number of revenue-raising measures and slowing of expenditures as the economic expansion takes hold.

But on basically raising revenues, I do not believe that we should lower taxes at that moment. I think the next time around, the burden should be put much more on monetary policy implementation to help restimulate the economy than the last time around.

Mr. PEASE. Thank you.

Mr. Rohatyn?

Mr. ROHATYN. I gather your question is what happens if we go into a recession a year from now, a year and a half from now, without any actions being taken in the meantime.

I would run for the hills. I think that the combination of things that can happen—I cannot—the reason I cannot answer the question is I cannot tell what would happen in the foreign exchange markets.

I think it is quite possible that you would have a capital flight as a result of expectation that we would just inflate our way out of another recession—combined with an increasing deficit that has to be financed.

Clearly, at that point, you would probably not want to raise revenues. What you do about the banking system, what you do about the credit situation, what you do about the dollar situation, how you finance yourselves in the meantime, taking into account that not only the Government, but the corporate sector is very burdened with debt right now—it is just not a risk that I would be willing to run.

I think that you would be facing economic and financial options that none of us have lived through in our experience. And that would be very destabilizing, very, very troublesome.

Mr. PEASE. When I talk with my constituents, I describe to them what I call the worst-case scenario—our economy entering into another recession in 1985, before Congress has a chance to put into place deficit reduction measures.

I gather from what you have said, Mr. Rotahyn, you would agree with me that worst case is the proper description for such a situation?

Mr. ROHATYN. Yes, I think potentially, certainly.

Mr. PEASE. You said, Mr. Kaufman, in your testimony that deficit projections have been substantially different over the years from actual deficits. What were the projections? Were those official OMB projections or a composite of private forecasts or what?

Mr. **Kaufman**. Those where the official projections coming out of the Office of Management and Budget, and all I did was to take those over a period of time and lay them against the actual results.

They did not reflect private sector estimates.

Mr. **Pease**. All right. Finally, Mr. Kaufman, in your testimony you mentioned that the deficit will start to crowd out private demanders of credit and will drive their debt service burden even higher.

Mr. **Kaufman**. Yes.

Mr. **Pease**. I have been saying that for about a year and a half now, telling my constituents that these big deficits are going to catch up with the administration and lead to much higher interest rates. It hasn't happened thus far, and the optimistic person we have at the White House now would probably say if it hasn't happened yet, it is not going to happen.

If it hasn't happened thus far, despite the predictions a year ago of many people, what makes you think it might happen in the future?

Mr. **Kaufman**. What has happened thus far, in part because of the large budget deficit, in part because of financial innovations to which the deficit has contributed, the private sector—business and consumers—have shifted their financing into the short maturity sector.

Floating interest rates hinged to money rates, floating prime, commercial paper financing, adjustable rate mortgage financing, has resulted in a shift from long-term financing to short-term borrowing.

The Government has dominated the long-term sector. We have moved now out of recession into economic expansion. Therefore, in this early phase, we have been able to accommodate the private sector, because we have been able to push it into the short maturity range where interest rates fluctuate.

But as we go on into the third year of economic expansion, with less leeway, with very strong credit demands coming into place, there will be also a push on that short-term rate if, as I expect the inflation will heat up somewhat from what we have had—if we have to continue to provide inducements to foreigners to bring their money here and to hold it on shore—under those circumstances, the short rate will have to lift at some point in time, and imperil the private sector which has refuge in the short maturity area.

That will happen, I suspect, sometime in 1985. The initial crowding out you are talking about was of the invisible kind. The private sector has been crowded into the short area.

Now, the push comes into that short area from different circumstances as we go on in this economic expansion.

Mr. **Pease**. Thank you very much.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Archer will inquire.

Mr. **Archer**. Thank you, Mr. Chairman.

Mr. Kaufman, I certainly agree with your last comment. I must quickly say that at a time when we have one of the highest real interest rates in the history of the country, we cannot say that it is not already impacting today in real terms as far as the interest rate above the rate of inflation is concerned.

I think we are reaping the results of that now, and I would tend to agree with you that I think it is going to be worse.

I must say, however, that if we are a mature society of people who will make sound judgments, I would think that you would agree that we did not reach that maturity in the past 2 or 3 or 4 years, that we have been there for a while.

Would that be correct?

Let me just pursue it further, because I believe if we are mature today, we had the same maturity 5 years ago. And if we are mature and we can do all of these wonderful things without a constitutional amendment mandating a balanced budget, I wonder why we are where we are today.

And sadly enough, and I say this gratuitously, I think you are naive if you think that human nature and the flaws in human nature have been changed by what you state as a maturity that has come to us at this time.

But I would rather move on. I just want to make that comment.

I wanted to ask Mr. Rotahyn, you mentioned specifically that you would have an oil import fee. And I must say that that has a seductive ring to it. Would you also return to an entitlements program as a result of that?

Mr. ROHATYN. No, I would not.

Mr. ARCHER. So you would leave a disparity for those who had domestic production and a cheaper price than the foreign oil, you would leave them an advantage in the marketplace?

Mr. ROHATYN. No, I would tax both domestic——

Mr. ARCHER. So it would be a tax on domestic oil as well as on imported oil in equal amount.

Mr. ROHATYN. That is right.

Mr. ARCHER. Have you run out the economic results relative to our petrochemical industry and our ability to compete overseas as a result of having a higher price on their raw materials than competitors in other nations in the world?

Mr. ROHATYN. First of all, I don't believe the other nations in the world have higher prices on oil than we do.

Mr. ARCHER. If we put an import fee on the crude oil coming into this country, you don't think that would create a higher price of raw materials for our manufacturers?

Mr. ROHATYN. Most countries in the world are buying oil in dollars, which is now gone up about 30 percent vis-a-vis the European currencies.

Mr. ARCHER. We are, too. That would be the same. But what you would effectively do is create a higher raw material price for our entire petrochemical industry, and I assume that you would then have some exception for—from your tax for the home heating oil for the northeast.

I assume that you would——

Mr. ROHATYN. I think you are assuming incorrectly. I would have no exceptions.

Mr. ARCHER. How can we compete domestically and internationally when we are right on the ragged edge now with the petrochemical industry. You both have talked about how we have got to increase our exports. We have got a $10 billion net surplus in our petrochemical industry today.

That would be completely erased if you put them on a different competitive basis relative to the foreign petrochemical industry.

Mr. **ROHATYN**. I am not arguing for or against the petrochemical industry, Mr. Archer. And it might be that the petrochemical industry would have to make some efforts to increase its productivity. On the other hand, there are a lot of countries in the world today that think that our petrochemical industry has about a 30-percent cost advantage because of the value of the dollar over what their crude oil imports cost them in Germany or in France or in the United Kingdom.

So I am not saying that this would be a costless or a painless exercise. I may be wrong.

Mr. **ARCHER**. I think you have not thought it through. I think your answer is not really the point, either, because we have got to sell our products in dollars just like we have to buy our crude oil in dollars.

Mr. **ROHATYN**. I understand that.

Mr. **ARCHER**. So the price of oil is going to create a disparity for the people in this country compared to what is going into foreign refineries in the petrochemical industry. I think you better think that through before you publicly get out and say that is the answer to our problems.

Because I will tell you it is going to create more problems than it is going to answer.

Mr. **ROHATYN**. It is just a difference in judgment.

Mr. **ARCHER**. No. It is a reality. I just don't think you have thought it through to its final conclusion.

Mr. **ROHATYN**. I understand.

Mr. **ARCHER**. Thank you very much.

Chairman **ROSTENKOWSKI**. Mr. Frenzel will inquire.

Mr. **FRENZEL**. Mr. Chairman and gentlemen, I thank you very much for coming here. I am sorry we are getting you late to the lunch table.

The testimony of each of you has been exceedingly helpful. Both of you paint a very dismal picture of the future—if the Congress refuses to act. None of us would be sitting in these seats if we were not cock-eyed optimists.

And yet, based on Congress' track record, particularly the recent history, there is nothing to make any of us believe that Congress is suddenly going to smarten up.

Both of you have been here before, both you have uttered similar warnings. How much time do we have? Both of you have indicated that this requires some timely action on the part of Congress.

Mr. Kaufman indicated something about a cyclical average length of 3.8 years. Are we talking about big trouble in calendar 1985 if we don't act in the first half of 1985?

Mr. **KAUFMAN**. My belief, under current circumstances, the economic expansion bill probably endure through 1985. But if there is to be an effective fiscal response, it will require congressional legislation early in 1985 to reduce the budget deficit so that we can elongate the economic expansion as we move from a much slower pace of economic expansion in the second half of 1985 into the risky time period, which will be the latter part of 1985 and 1986.

That is where the difficulty will be, and unless you move now, meaning when the election is over, you move in January and February to quickly begin the legislative process, I think you run the risk that in 1986, efforts to slow the budget deficit and to reduce it will coincide with the weakening tendencies in the economy.

Mr. **Frenzel**. I appreciate the timely warning. The trouble is the Congress doesn't even appoint committees until February, at least the House doesn't, and we dawdle along. I tend to agree with you.

Mr. Rohatyn, do you have any opinion as to what the rescue timeframe is?

Mr. **Rohatyn**. I agree with Henry. I think from most of what we can see in terms of the business of corporations that we work with, in terms of their expectations, their current business, their forecasts, I think things look pretty good until about—I mean about as far as one can see clearly, which is the third quarter of 1985.

After that, nobody knows, and you are getting into an area of conjecture.

So, I would think if you want to be on the safe side and in view of the risks involved here, I would certainly want to be on the safe side, I think the earlier you move next year, or if there is any possibility of the discussion of Senator Dole of having some kind of a postelection summit on the budget, that would be even better.

You are dealing with tricky psychology in foreign exchange markets. You have a very, very exposed, unbalanced situation there, and nobody has paid any attention to what technology has done to the volatility of exchange rates, because overnight, you can transfer $20 billion out of one place to another, and these things feed on themselves.

I think these are things one has to be very careful of.

Mr. **Frenzel**. Mr. Kaufman, do you share Mr. Rohatyn's enthusiasm for summitry?

Mr. **Kaufman**. Only if you can bring together a good coalition of Americans, people within the Congress from both sides, a summitry that is exceedingly well-managed rather than a political forum for public opinion.

We had a commission, of course, on the Social Security effort that worked quite well. I do not disagree with summitry, but I am a little bit skeptical that it should not become a public forum.

It should become a hard-working commission that is going to have deadlines attached to it and make definitive recommendations, and a commission that will come back within a short period of time rather than one that will have a very long life.

Mr. **Frenzel**. Mr. Rohatyn, because we do not have any authority, congressionally, to establish such a commission or summit meeting, I assume that you are referring to something that the chairman described as the need for leadership from the White House for such a meeting?

Mr. **Rohatyn**. I would think such a meeting couldn't be considered without the President wanting it and leading the way for it.

Mr. **Frenzel**. Your assumption is that he would call it?

Mr. **Rohatyn**. My assumption is that if he didn't, it would be a waste of time.

Mr. **Frenzel.** My assumption is that we can't ever make your timeframe without some kind of outside roadmap or instructions from such a group. Congress simply cannot pull itself together quickly enough to do the job that you recommend before we get into the area of uncertainty, that is, the end of the first half of 1985.

I thank you both for your testimony. I think it has been at least your predictions of what is going to happen to us if we don't make changes have been very helpful. And I thank you both.

Chairman **Rostenkowski.** I want to express my gratitude once again. However, I want to make one concluding observation with respect to our experience with the so-called shadow government of commissions. My experience has been that commissions come up with solutions to the easy problems and only options on the hard problems. In most instances, the tough decisions are made right here, and that is as it should be.

We are elected to make the tough decisions. Although we have only taken small deficit reduction steps in my opinion, I think that we have taken steps in the right direction. I would like to thank you again for presenting some thought-provoking statements. I realize, and hope that others do too, that here in the Committee on Ways and Means—and in the Senate Finance Committee—is where the tough decisions will be made.

I want to reiterate that those decisions will never be made unless we have Presidential leadership, and a bipartisan effort with everybody participating—the executive as well as the legislative branch.

Thank you very much, gentlemen.

The Chair calls Mr. Wenglowski. Thank you for joining us. It is nice to see you again. The committee is ready to receive your testimony.

STATEMENT OF GARY M. WENGLOWSKI, GENERAL PARTNER AND DIRECTOR OF ECONOMIC RESEARCH, GOLDMAN, SACHS & CO.

Mr. **Wenglowski.** Thank you, Mr. Chairman.

My name is Gary Wenglowski. I am the director of economic research and a general partner of the investment banking firm of Goldman, Sachs & Co., and I am pleased to have the opportunity to express my views before this committee.

My prepared remarks focus on what I think is the newest and most important element complicating the solution to the Federal budget deficit problem.

Before getting into that, I would like to give you briefly my view on the direction of the economy at the moment, the meaning of the recent economic statistics of a slowdown, and the near-term outlook for interest rates.

In both economic growth and interest rates, I think we are experiencing what I would best call a temporary breather for a few months.

The causes of the slowdown that we are experiencing are the summer lull in consumer spending, and the sharp increase in import penetration of many U.S. markets during the summer, which have caused an excess rate of inventory building that is now being worked down.

It is my best judgment that the slowdown will be mild and brief for the following reasons: The determinants of consumer spending are still very positive. We have had one of the strongest gains in real consumer incomes in over 25 years in the past 12 months, and the recent recovery in stock prices has added about $150 billion to the market value of consumer asset holdings.

The strong recovery in capital spending appears to be intact with the latest data on capital appropriations showing a 38-percent increase, which is the biggest gain on record. And Federal Reserve policy continues to be accommodative and expansive.

So I would expect that after this slowdown, real economic activity would reaccelerate and after interest rates being flat to down in the next few months, we would expect significant increases in interest rates in 1985.

I would like to emphasize that we are now entering however a much more uncertain phase of this business recovery. In part, this is because of the usual reason, that uncertainty always increases as a business cycle matures.

But in addition in this particular cycle, the uncertainty is compounded by the rising foreign trade deficit and the soaring dollar exchange rate, both of which can be linked to the Federal deficit, and the near impossibility of predicting how high the foreign trade deficit will go and when the dollar exchange rate will reverse.

Both of those factors would seem extremely important to the outlook for the economy and I point out that they are the least predictable.

The theme of my prepared remarks is that although some progress has been made toward reducing the Federal deficit, it has been insufficient to prevent the development of another major imbalance in the foreign accounts of the United States.

Continued deterioration in the U.S. foreign trade balance and the possibility of significant downward pressure on the dollar exchange rate now complicate the environment for future actions to reduce the deficit.

So, in a word, we have waited too long.

The evidence of progress toward deficit reduction shows up in this fiscal year's outlays. They should rise only about 6.2 percent over 1983 levels. That would continue a decelerating trend in outlay growth.

In 1981, outlays grew by 14 percent, in 1982 by 10.8 percent, in 1983 by 9.3 percent, and this year by 6.2 percent.

Also, the Deficit Reduction Act, recently legislated, will reduce the deficit by close to $65 billion over 4 years.

Economic growth has been stronger than expected, putting downward pressure on the deficit. Despite these positive developments, however, the latest midsession review of the budget estimates the deficit for this fiscal year and next to be essentially the same as the projections made over 1 year ago.

The budget's stimulative impact, together with the Federal Reserve Board's shift to an expansive monetary policy in the second half of 1982 were, in my opinion, the most important forces behind the unusually strong economic recovery of the past 18 months.

The strong recovery in the face of very high interest rates reflects the fact that consumer spending and saving and business investment in the United States are relatively insensitive to interest rate changes.

Our tax laws as well as innovations in the financial markets contribute to this insensitivity of U.S. saving and investment to interest rates.

For example, the unlimited tax deductibility of consumer interest costs and the taxation of most consumer interest income results in aftertax interest rates which are not nearly as high relative to current inflation for consumers as they appear before you consider the consequences of our tax laws.

As for innovation, lower interest rates on adjustable rate loans and longer maturities of consumer loans have been used to offset the impact of higher interest rates on consumer borrowing.

Business investment is not significantly affected by rising interest rates in a direct way because expected rates of return on new investment projects in the United States far exceed interest rate levels and these rates of return were boosted by the recent acceleration of depreciation allowances.

Therefore, interest rates have risen to present levels because of the interest insensitivity of U.S. saving and investment and because the Federal deficit absorbed 75 percent of U.S. saving in 1983 and close to 60 percent in 1984.

Another result of the high deficit and the relative interest insensitivity of the U.S. economy has been the major deterioration in our foreign trade deficit.

This companion deficit to the imbalance in the Federal budget has created an inflow of saving from abroad which has been very beneficial in the short run. It allowed a nearly normal recovery in U.S. investment despite the large Federal deficit.

I think it is important to anticipate when the foreign trade deficit will become a negative force in the overall economic environment, and to do that, I think it is important to understand why the record rise in the trade imbalance to date has had little adverse impact on overall economic growth.

Between the fourth quarter of 1982, when the last recession ended, and the second quarter of 1984, the trade deficit rose by $70 billion to a $120 billion annual rate.

Yet, the economy has experienced its strongest recovery in domestic production since the early 1950's and a soaring dollar exchange rate.

The reason for this benign increase in the trade deficit was, first, that the rising stimulus to the domestic economy from the Federal deficit and monetary policy offset the foreign sector's deterioration.

At the same time, the strong demand for dollar-denominated assets abroad and, in addition, reduced U.S. bank lending abroad offset the depressing effect on the dollar exchange rate that would normally accompany such a deterioration in the foreign trade account.

However, the sheer magnitude that the trade deficit has recently attained suggests that we may be entering a period when its effects on economic activity and the exchange rate may finally become negative.

The latest available monthly trade deficit passed what I think is an important milestone. Last July's deficit in trade, the latest available figure, was $169 billion at an annual rate, an increase of $50 billion from the second quarter's average.

If July's rate of trade deficit were sustained, the increase in the trade deficit since 1980 would begin to exceed the rise in the Federal budget deficit over the same period of time.

In 1980, the unified budget was in deficit by $59.6 billion, compared with the latest fiscal year 1984 projection of $174.3 billion, for an increase of $115 billion.

The 1980 trade deficit was approximately only $36 billion, compared with last July's $169 billion annual rate, for a gain of $133 billion.

So the imbalance in the trade account is beginning to exceed the increase in the Federal deficit. As the trade deficit begins to exceed the Federal deficit, it may begin to weaken the strength of the current U.S. recovery.

Certainly, adroit management of monetary policy would be necessary to prevent that result. In fact, although we believe that the recent evidence of slower economic growth will be short lived, it can be traced to inventory imbalances in many U.S. industries which are being caused by the recently increased import penetration of U.S. markets.

A sustained trade deficit of July's magnitude could also eventually cause the long-awaited decline in the dollar's foreign exchange rate. The most widely accepted explanation for the dollar's strength has been that it is a result of the shortage of saving in the United States and high interest rates created by the Federal deficit in the United States.

If the trade deficit is now creating a saving flow from abroad which is beginning to exceed the increase in the Federal deficit, the most popular rationale for a rising dollar would no longer be present.

Particularly worrisome to me are the long timelags in the impact of a changing dollar exchange rate on the trade deficit. These lags suggest that the trade imbalance could increase further in coming months due to the dollar's recent surge.

There are also very long timelags between changes in the actual volume of dollars flowing abroad and the changes in the desired dollar holdings of foreigners.

The foreign willingness to accept increased holdings of U.S. dollars could change overnight as expectations concerning U.S. economic conditions, business conditions abroad, or the world political balance vary.

However, the elimination of the deficit in the current account of the U.S. balance of payments would be necessary to stop the buildup of dollars in the hands of foreigners. In the interim, the dollar exchange rate would be under significant downward pressure for a protracted period of time.

In conclusion, an imbalance in the foreign sector of the United States has developed which is now as large as the imbalance in the Federal deficit. The equivalence is no accident. Further actions to reduce the deficit must be considered in light of the effects on the economy from a rising trade imbalance and the possibility of a declining dollar exchange rate.

I think this presents a true dilemma. Because of the timelag between changes in the exchange rate and their effect on the trade balance, an increasing trade imbalance and declining exchange rate could take place together for a period of time. They would have the contrary effects of weakening economic growth and raising U.S. inflation for a period of time, which is a very difficult combination of conditions to compensate for in economic policy.

In my opinion, deficit reduction should nevertheless continue to be a No. 1 priority. At the same time, monetary policy should also be carefully controlled by the Federal Reserve Board to offset the weakening of business activity and to not aggravate the decline in the dollar.

Although it may be impossible to fully achieve both of these objectives, a reasonable compromise may be a monetary policy characterized by a continued expansion of M1 in the 7-percent area, which is what we have seen recently.

This would seem stimulative enough to limit an economic slowdown and not so expansive as to accentuate the downward pressures on the dollar.

Specific actions to reduce the budget deficit I think should also be considered in light of their effect on the foreign trade sector and the willingness of foreigners to hold dollar-denominated assets.

Thank you.

[The prepared statement follows:]

STATEMENT OF GARY M. WENGLOWSKI, CHIEF ECONOMIST AND GENERAL PARTNER, GOLDMAN, SACHS & CO.

My name is Gary M. Wenglowski. I am the Director of Economic Research and a general partner of the investment banking firm of Goldman, Sachs & Co. and I am pleased to have the opportunity to express my views before this committee.

The theme of my remarks is that although some progress has been made toward reducing the federal deficit, it has been insufficient to prevent the development of another major imbalance in the foreign accounts of the United States. Continued deterioration in the U.S. foreign trade balance and the possibility of significant downward pressure on the dollar exchange rate complicate the evironment for future actions to reduce the deficit.

Evidence of progress toward deficit reduction shows up in this fiscal year's outlays. They should rise only about 6.2% over 1983 levels. That would continue a decelerating trend in outlay growth -- 14% in 1981, 10.8% in 1982, 9.3% in 1983. Also the Deficit Reduction Act legislated by Congress will reduce the deficit by close to $65 billion over four years. Economic growth has been stronger than expected, putting downard pressue on the deficit. Despite these positive developments, however, the latest Mid-session Reveiw of the budget estimates the deficit for this fiscal year and next to be essentially the same as the projections made over a year ago. Higher than anticipated interest rates and so-called technical reestimates of budgetary receipts and outlays have offset the positive developments on the budgetary front.

The budget's stimulative impact together with the Federal Reserve Board's shift to an expansive monetary policy in the second half of 1982 were the most important forces behind the unusually strong economic recovery of the past 18 months. The strong recovery in the face of high interest rates reflects the fact that consumer spending and savingand business investment in the United States are relatively insensitive to interest rates changes. Our tax laws as well as innovations in the financial markets contribute to this insensitivity to interest rates.

The unlimited tax deductability of consumer interest costs and the taxation of most consumer interest income results in after tax interest rates which are not nearly as high relative to current inflation for consumers as they appear before taxes are considered. Busines investment is not directly affected signficantly by rising interest rates because expected rates of return on new investment projects far exceed interest rate levels and these returns were boosted by the recent acceleration of depreciation allowances.

Interest rates have risen to present levels because of the interest insensitivity of U.S. saving and investment and because the federal deficit absorbed 75% of U.S. net saving in 1983 and close to 60% in 1984. Another result of the high deficit and relative interest insensitivity of the U.S. economy has been the major deterioration in our foreign trade deficit. This companion deficit to the imbalance in the federal budget has created an inflow of saving from abroad which has been very beneficial in the short-run. It allowed a nearly normal recovery in U.S. investment despite the large federal deficits.

In order to help anticipate when the foreign trade deficit will become a negative force in the overall economic environment it is important to understand why the record rise in the trade imbalance so far has had little adverse impact. Between the fourth quarter of 1982 when the last recession ended and the second quarter of 1984 the trade deficit rose by $70 billion to a $120 billion annual rate. Yet the economy has experienced its strongest recovery in domestic production since the early 1950s and a soaring dollar exchange rate. The reason for this benign increase in the trade deficit was that the rising stimulus to the domestic economy from the federal deficit and monetary policy offset the foreign sector's deterioration. At the same time, the strong demand for dollar-denominated assets abroad and reduced U.S. bank lending abroad offset the depressing effect on the dollar exchange rate that would normally accompany such a deterioration in the foreign trade account.

The sheer magnitude that the trade deficit has recently attained, however, suggests that we may be entering a period when its effects on economic activityand the exchange rate may become negative. The latest available monthly trade deficit passed an important milestone. Last July's deficit in trade was $169 billion at an annual rate, an increase of $50 billion from the second quarter's average. If July's rate of trade deficit were sustained, the increase in the trade deficit since 1980 would begin to exceed the rise in the federal budget deficit over the same period. In 1980 the unified budget was in deficit by $59.6 billion, compared with the latest fiscal 1984 projection of $174.3 billion, for an increase of $115 billion. The 1980 trade deficit was approximately $36 billion, compared with last July's $169 billion annual rate, for a gain of $133 billion.

As the trade deficit begins to exceed the federal deficit, it may begin to weaken the strength of the current U.S. recovery. Adroit management of monetary policy would be necessary to prevent that result. In fact, although we believe that the recent evidence of slower economic growth will be short lived, it can be traced to an inventory imbalance in many U.S. industries caused bythe recently increased import penetration of U.S. markets.

A sustained trade deficit of July's magnitude could also eventually cause the long-awaited decline in the dollar's foreign exchange rate. The most widely accepted explanation for the dollar's strength has been that it is a result of the saving shortage and high interest rates created by the federal deficit in the United States. If the trade deficit is now creating a saving flow from abroad which is beginning to exceed the increase in the federal deficit the most popular rationale for a rising dollar would no longer be present.

Particularly worrisome are the long time lags in the impact of a changing dollar exchange rate on the trade deficit. They suggest that the trade imbalance could increase further in coming months due to the dollar's recent surge. There are also long time lags between changes in the volume of dollars flowing abroad and changes in the desired dollar holdings of foreigners. The foreign willingness to accept increased holdings of U.S. dollars could change quickly as expectations concerning U.S. economic conditions, business conditions abroad, or the world political balance vary. However, an the elimination of the deficit in the current account of the U.S. balance of payments would be necessary to stop the build-up of dollars in the hands of foreigners. In the interim, the dollar exchange rate would be under significant downward pressure.

In conclusion, an imbalance in the foreign sector of the United States has developed which is now as large as the imbalance in the federal deficit. This equivalence is no accident. Further actions to reduce the deficit must be considered in light of the effects on the economy from a rising trade imbalance and the possibility of a declining dollar exchange rate. This presents a true dilemma since an increasing trade imbalance and declining exchange rate would have the contrary effects of weakenening economic growth and raising the U.S. inflation rate for a period of time.

In my opinion, deficit reduction should continue to be a number one priority. At the same time, monetary policy should also be carefully controlled by the Federal Reserve Board to offset the weakening of business activity and to not aggravate the decline in the dollar. Although it may be impossible to fully achieve both of these objectives, a reasonable compromise may be a monetary policy characterized by a continued expansion of M1 in the 7% area. This would seem stimulative enough to limit an economic slowdown and not so expansive as to accentuate the downward pressures on the dollar. Specific actions to reduce the budget deficit should also be considered in light of their effect on the foreign trade sector and the willingness of foreigners to hold dollar-denominated assets.

Mr. **Pease** [presiding]. Thank you very much, Mr. Wenglowski. We appreciate your testimony. And we will turn first for questions to Mr. Conable.

Mr. **Conable**. Thank you.

There are lots of dilemmas here, aren't there? If we reduce the budget deficit, we would have a significant impact on inflationary expectations, I suppose, and it would tend to reduce the interest rate which would make foreign investment less attractive and that could encourage an outflow right there, while, as you say, we would have a rather protracted time period before that showed up in improved trade balance.

You say the best thing to do is to reduce the deficit, but if we were to do that so credibly that the interest rate came down significantly, we would have an outflow of foreign capital on that account, wouldn't we?

Mr. **Wenglowski**. I think, however, that we have to reach a longer term equilibrium where the capital inflow is lower and the dollar is at a more reasonable exchange rate.

Mr. **Conable**. I am concerned about short-term impact of what we do. Almost any policy has to be gradual if we are not to have some very severe short-term imbalance. If we should have a sudden flight of foreign capital from this country, obviously interest rates would go back up, wouldn't they?

Mr. **Wenglowski**. They would. I would make two comments on this. One is it may be impossible to unwind the degree of imbalance that we have developed in the exchange rate and in the foreign capital flow totally smoothly.

Second, I would encourage you and this committee to really consider monetary policy as probably the better to offset——

Mr. **Conable**. How do we impact that in this committee or any other committee of the Congress without in all probability imposing additional guidelines that would be viewed in many quarters as political interference with an important element in the checks and balances on fiscal excess?

Mr. **Wenglowski**. I think it is more of a question of depending on the Federal Reserve to act flexibly under these conditions and creating a fiscal policy which gives them the maximum room for acting flexibly.

Mr. **Conable**. I agree with that, yes.

Mr. **Wenglowski**. One point that I would make is, it came up earlier in the committee discussions this morning is I think there is a tendency to believe that you must take contracyclical fiscal action to stop a recession.

This is because it is hard to have the confidence in monetary policy, because it operates in so much more of an abstract way, whereas tax cuts and spending changes are clearly measurable.

A recent experience that I think underlines the strength of monetary policy compared to fiscal policy is that, even though we had tax cuts and a budget moving dramatically into deficit in 1981 and 1982, we continued to have a significant recession in the United States.

We had a tax cut in October 1981, a tax cut in July 1982, yet the recession persisted until November 1982. It was not really until monetary policy was eased that the recovery began.

I think from that, you can have confidence that monetary policy could offset a lot of these negative conditions in the short run and that fiscal policy should be aimed toward the longer run goals.

Mr. **Conable**. Thank you, Mr. Wenglowski.

Mr. **Pease**. Mr. Frenzel will inquire.

Mr. **Frenzel**. Mr. Chairman, I have no questions. I want to thank the witness for his testimony.

Mr. **Pease**. Mr. Wenglowski, might I just ask you what your sense of urgency is? Other witnesses this morning suggested that we don't have much time, that if we don't act early in 1985, there will be all sorts of deleterious effects. Is that opinion shared by you?

Mr. **Wenglowski**. Yes. I would share that opinion. I think one sees the imbalance in the Federal budget breeding imbalance in other sectors of the economy which are creating complications for solving the deficit and creating a much more complicated problem, and in many respects, we could, I think, even say that we have waited too long already.

I certainly think it should be done as quickly as possible, and in this regard, I would raise the question whether introducing the concept and the question of tax reform doesn't further complicate the issue and run the risk of delay at this point in time.

Mr. **Pease**. One other question.

Obviously, our export market is suffering significantly, partially because of the strong dollar, and is contributing to the large trade imbalance that you mention.

Do you have any feel at all for how seriously our export industries are being harmed over the long run? In other words, are they suffering short-term reverses because of price competition or are they in any sense losing a competitive edge which might last beyond a change in the dollar value vis-a-vis other currencies?

Mr. **Wenglowski**. I think there are probably some cases where there is longrun damage being done. Certainly when you put weaker companies out of business you have created a long-term effect.

On the other hand, I would say that in most cases, this would tend to be a shortrun factor as long as the dollar imbalance were corrected fairly soon.

We see in industries that are stronger financially, that the strength of the dollar is actually encouraging actions to make them more competitive and stronger. So the strong dollar is not without beneficial impacts on the stronger industries and companies in the country. But for those who are weaker, I think the effects will be more lasting.

So, I would believe as long as it could be reversed soon, the effects would be by and large temporary.

Mr. **Pease**. Thank you very much, Mr. Wenglowski. We appreciate your testimony very much. The hearing will be recessed until 1:30 p.m.

[Whereupon, at 12:55 p.m., the committee recessed, to reconvene at 1:30 p.m.]

Chairman **Rostenkowski**. The Chair calls Mr. Pierre Rinfret. Mr. Rinfret, welcome to the committee. I know we have had past opportunities to have the benefit of your testimony. It is always a pleasure to have you back with us, to receive the benefit of your views. You may proceed.

STATEMENT OF PIERRE A. RINFRET, PRESIDENT, RINFRET ASSOCIATES, INC.

Mr. **Rinfret**. Thank you, Mr. Chairman.

It is a pleasure and honor to be here. I have distributed, as you know, a document which we have put together in regard to the outlook for the Federal budget.

I just want to make four very simple points about the Federal budget. I would remind you, Mr. Chairman, if I may, that I am not a Republican nor a Democrat. I am an analyst.

I try to call it as I see it. And I want to talk about what I consider probably the second most pressing economic problem in the United States, the Federal budget.

The first point I would like to make is that it is very popular these days to think or to conceive of the fact that you can grow out of the deficit if we just let the economy continue to grow. And that, in fact, economic growth in and of itself will generate the receipts necessary to balance the budget.

I don't believe it. We have looked at the Federal budget receipt side of it under existing tax laws and existing tax receipts, and we have maximized the economic growth potential for the United States in the next 5 years at a 5.5 percent real per year, which would be superb under any circumstances, and that is not adequate to balance the budget.

Second, a program to balance the budget by tax increases alone just cannot work. If we try and balance the budget by raising the taxes equivalent to $180 billion to get rid of the deficit, all we will do is throw the economy into a tailspin and it will be a self-defeating procedure.

Third, an obvious truism—but nevertheless I think it needs to be iterated and reiterated. It seems to me if we are going to balance the Federal budget in the next 5 years, if that is the political objective, the only way to do it is to combine it with some form of increase in revenues and lower rates of spending increases—not lower rates of spending.

If we assume, and this is my fourth point, that this economy grows 5.5 percent per year, which I think it has the ability to do, in real terms for the next 5 years, and we can hold spending to 4.5 percent a year, we could balance the budget by 1989, and by balance I mean plus or minus $20 billion.

My conclusion is very simple, very obvious, not terribly startling, but rather basic. If your political objective is to achieve a relatively balanced budget within the next 4 to 5 years, you cannot do it by taxes alone, you cannot do it by spending cuts. What you have got to do is combine a modest increase in tax revenues with control over the rate of increase in spending.

And I backed it up. I asked myself what gets me a balanced budget by 1989 if I assume the economy grows 5.5 percent a year, which would be a notable economic record, with 3.5 percent inflation, and the answer is you could only have about a 3.4-increase in spending per year, which is now growing approximately 10 percent per year, at least in the last 4 years.

And I would like to merely make this statement. All the budget estimates which I have seen including the Congressional Budget Office for the next 5 years on the Federal deficit in my judgment totally underestimates the size of the Federal deficit in 4 to 5 years.

In our company we think it is entirely probable that the deficit, if spending goes unchecked and revenues are not increased, that we will have a deficit in 1989 of somewhere between $350 and $400 billion. And I would like to make one comment.

I do not think the deficit is devastating the American economy. I do not think it is destroying the American economy. But I do know one area in which it is crippling, and namely, that is interest rates. In my book, the only reason for the level of interest rates that we have got now is not inflation. It certainly is not private borrowing, either by industry or consumers.

But rather it is the enormity of the Federal deficit. We have already seen the peak in housing. Mortgage rates are destroying housing once again. We topped at 2.2 million annual rate of housing starts in February. We are currently running 1,550,000 housing starts and housing is going lower.

And I think what we are already beginning to see is a negative impact on this economic expansion as a result of interest rates. The continuation of the Federal deficit will keep interest rates up at these levels and as long as you do that, I assure you, you guarantee that young Americans, most Americans are not going to be able to afford a house in this country for the next 5 years.

My conclusion is rather simple, rather basic, perhaps a truism, but I think it is critical. If we are going to try to balance the budget, we have got to control spending, and we have got to have some forms of modest increases in tax revenues, because if we have big increases in tax revenues they will be self-defeating.

I thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF DR. PIERRE A. RINFRET, PRESIDENT, RINFRET ASSOCIATES, INC.

SUMMARY AND CONCLUSIONS

One. Economic growth in and of itself will not generate sufficient receipts to balance the Federal budget in the next five years.

Two. Tax increases large enough to (theoretically) balance the budget will be self-defeating.

Three. The only sensible way to balance the budget in the next four to five years is to increase revenue growth and lower spending growth.

Four. The budget could be balanced in fiscal year 1989 with a 5.5 percent annual GNP growth rate and a 4.3 percent increase in spending per year between 1984 and 1989.

Conclusion. In order to balance the Federal budget, revenue growth must be increased and spending growth must be decreased.

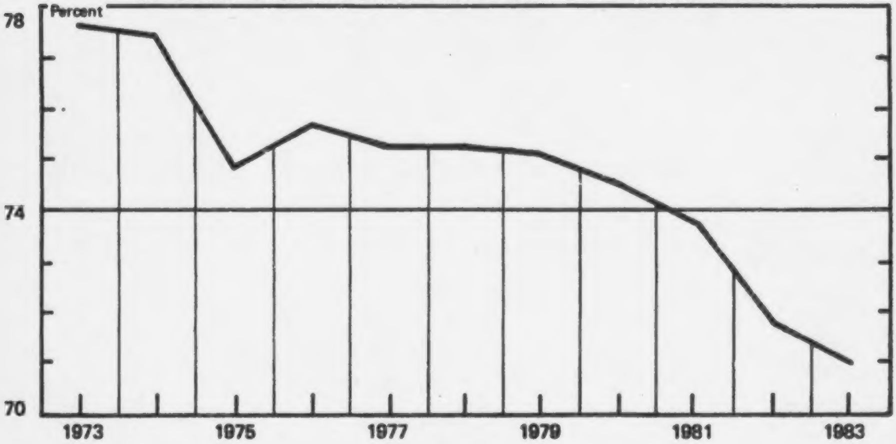
PART ONE: EROSION OF THE TAX BASE

- There has been a decline in the Adjusted Gross Income of individuals as a percent of their Personal Income.

Adjusted Gross Income As a Percent of Personal Income

Year	Percent	Year	Percent
1973	77.6	1979	75.1
1974	77.5	1980	74.5
1975	74.9	1981	72.8
1976	75.7	1982	71.8
1977	75.2	1983	71.0
1978	75.2		

ADJUSTED GROSS INCOME AS A PERCENT OF PERSONAL INCOME



Sources: U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the United States:1982-83, Statistics of Income, "Federal Individual Income Tax Returns With Adjusted Gross Income", page 255.
U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, "National Income and Product Accounts", Table 1.7.

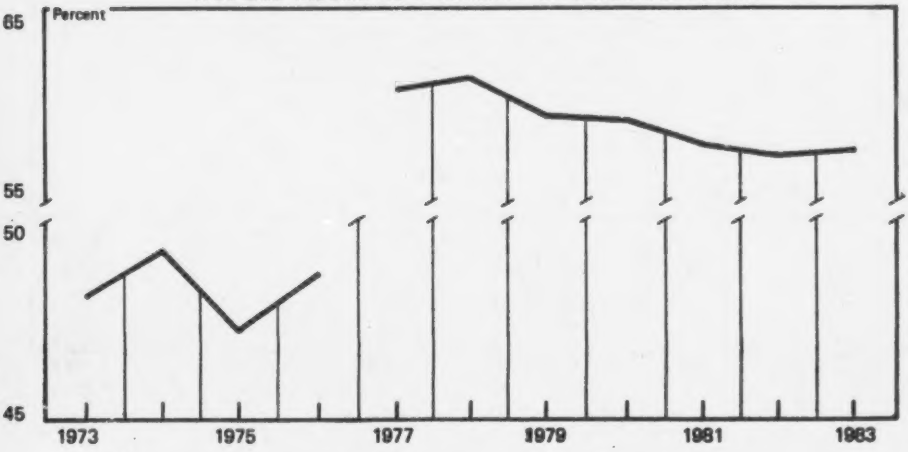
PART ONE: EROSION OF THE TAX BASE

- There has been a decline in Taxable Income of Individuals as a percent of their Personal Income.

Taxable Income As a Percent of Personal Income

Year	Percent	Year	Percent
1973	48.0	1979	59.3*
1974	49.1	1980	59.1*
1975	47.1	1981	57.9*
1976	48.5	1982	57.2*
1977	60.9*	1983	57.3*
1978	61.3*		

*Beginning with 1977, there is a break in the Taxable Income series due to the inclusion of the "zero bracket amount".


TAXABLE INCOME AS A PERCENT OF PERSONAL INCOME

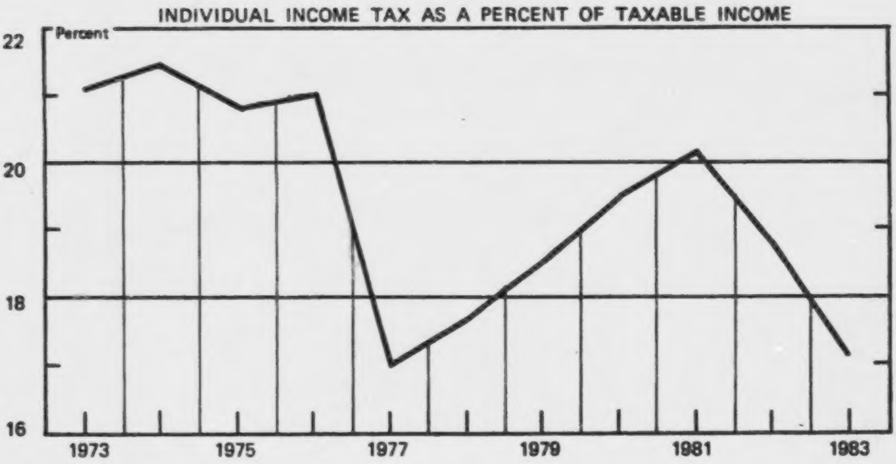
Sources: U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the United States: 1982-83, Statistics of Income, "Federal Individual Income Tax Returns With Adjusted Gross Income", page 255.
U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, "National Income and Product Accounts", Table 1.7.

PART ONE: EROSION OF THE TAX BASE

- There has been a decline in the amount of Income Tax paid by individuals as a percent of their Taxable Income.

Individual Income Tax As a Percent of Taxable Income

Year	Percent	Year	Percent
1973	21.1	1979	18.5
1974	21.5	1980	19.5
1975	20.9	1981	20.1
1976	21.0	1982	18.8
1977	17.0	1983	17.1
1978	17.7		


INDIVIDUAL INCOME TAX AS A PERCENT OF TAXABLE INCOME

Sources: U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the United States: 1982-83, Statistics of Income, "Federal Individual Income Tax Returns With Adjusted Gross Income", page 255.
U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, "National Income and Product Accounts", Table 1.7.

PART ONE: EROSION OF THE TAX BASE

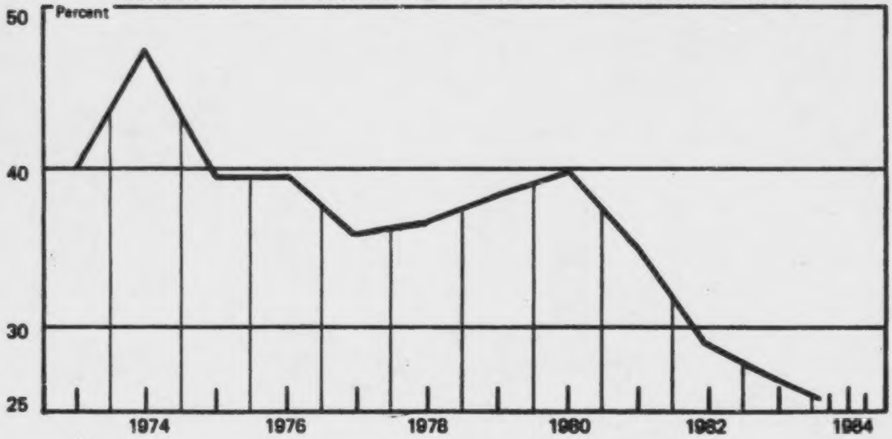
- There has been a decline in Corporate Tax Accruals as a percent of Corporate Profits. (These accruals consist of the amount of corporate income tax minus the investment tax credit, the foreign tax credit and other credits.)

Corporate Tax Accruals As a Percent of Corporate Profits(1)

Year	Percent	Year	Percent
1973	40.0	1979	38.1
1974	47.5	1980	40.0
1975	39.5	1981	35.5
1976	39.5	1982	29.2
1977	36.8	1983	26.8
1978	37.0	1984,2Q	26.0

(1) With Inventory Valuation Adjustment and Capital Consumption Allowance.

CORPORATE TAX ACCRUALS AS A PERCENT OF CORPORATE PROFITS



Source: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, "National Income and Product Accounts", Tables 1.7, 3.2.

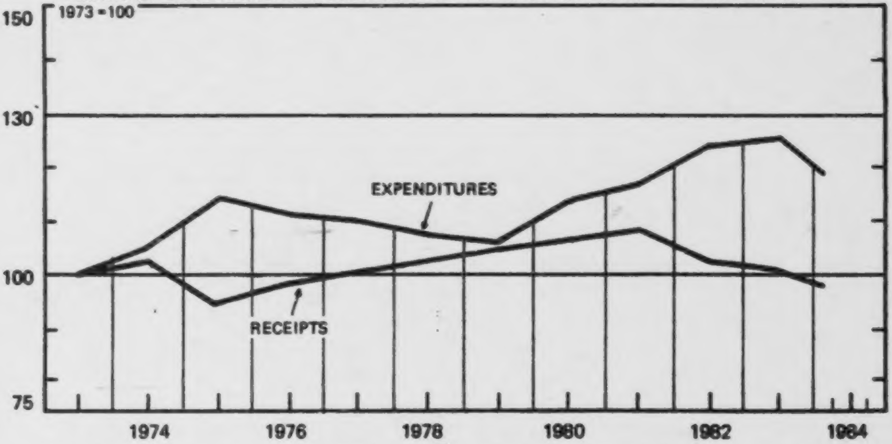
PART TWO: FEDERAL GOVERNMENT RECEIPTS AND EXPENDITURES

- Receipts have constituted a fairly stable share of the GNP.
- But expenditures have constituted an increasing share of the GNP.
- Federal expenditures in 1984 will be larger than the GNP of any other country in the world except Japan and the Soviet Union.
- Federal expenditures in 1984 will be almost twice the size of the GNP of the United Kingdom.
- Federal expenditures in 1984 will be 75 percent larger than the GNP of France.
- Federal expenditures in 1984 will be 33 percent larger than the GNP of West Germany.

1973=100: National Income and Product Accounts, Calendar-Year Basis

Year	Federal Receipts As a Percent of GNP	Federal Expenditures As a Percent of GNP
1973	100.0	100.0
1974	103.1	105.0
1975	94.9	115.6
1976	99.0	112.6
1977	100.5	110.1
1978	102.1	107.0
1979	104.6	106.0
1980	105.1	115.1
1981	109.2	117.1
1982	102.6	125.1
1983	100.0	125.6
1984,2Q	98.5	119.6

FEDERAL GOVERNMENT RECEIPTS AND EXPENDITURES AS A PERCENT OF GNP



Source: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, "National Income and Product Accounts", Tables 1.1, 3.2.

PART THREE: WHERE ARE WE GOING?

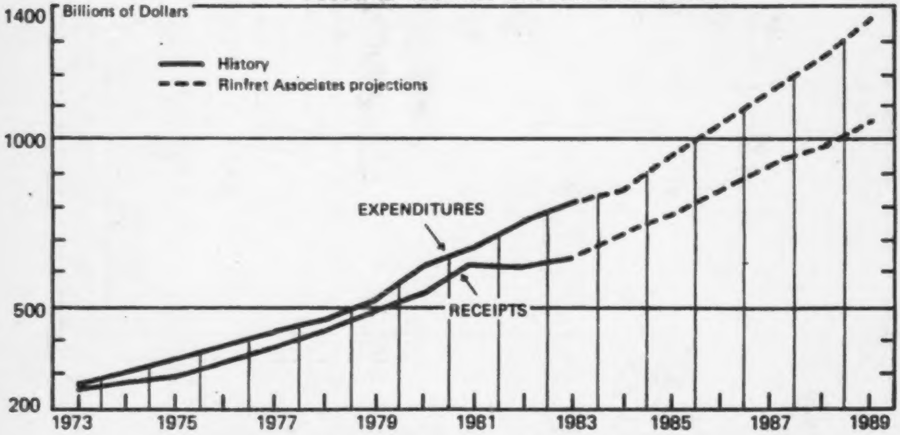
Case 1: The economy grows without a recession through 1989.

- This assumes that the real GNP will grow at a compound average annual rate of 4.0 percent and inflation at 3.5 percent per year.
- This assumes that Federal expenditures will continue to grow at an annual rate of 9.6 percent, which is the compound average annual growth rate of the past four years.
- In this case, Rinfret Associates projects the resulting receipts and expenditures as follows:

Billions of Dollars: National Income and Product Accounts, Calendar-Year Basis

Year	Federal Receipts	Federal Expenditures	Year	Federal Receipts	Federal Expenditures
1973	258.6	264.2	1984(e)	702.2	867.2
1974	287.8	299.3	1985(e)	791.4	950.4
1975	287.3	356.6	1986(e)	850.6	1041.6
1976	331.8	384.8	1987(e)	914.6	1141.6
1977	375.2	421.1	1988(e)	983.2	1251.2
1978	431.6	461.0	1989(e)	1057.0	1371.4
1979	493.6	509.7			
1980	540.9	602.1			
1981	624.8	689.1			
1982	616.7	764.9			
1983	641.1	819.7			

FEDERAL RECEIPTS AND EXPENDITURES



Source: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, "National Income and Product Accounts", Table 3.2. All projections (e) by Rinfret Associates, Inc.

PART THREE: WHERE ARE WE GOING?

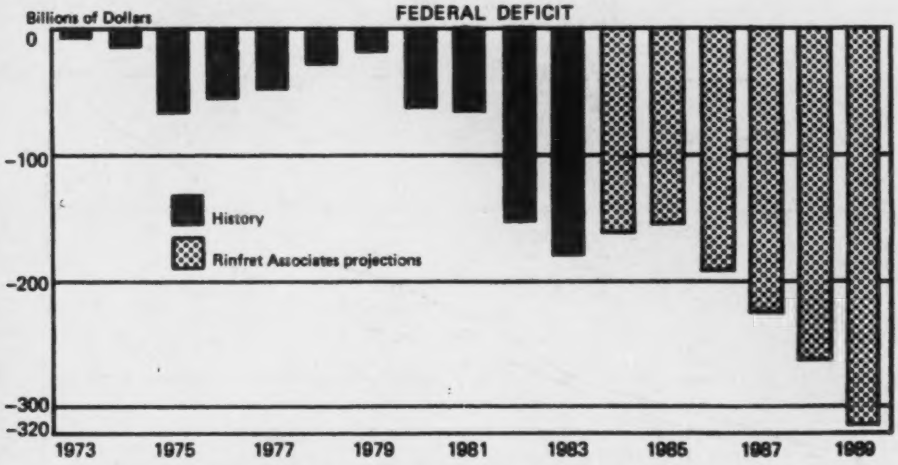
Case 1: The economy grows without a recession through 1989.

- This assumes that Federal spending will continue to grow at the 1980-84 pace of 9.6 percent, with a real GNP growth rate of 4 percent and an inflation rate of 3.5 percent per year.

- In this case, Rinfret Associates projects that the Federal deficit will be increasing as follows in the 1984-89 period:

Billions of Dollars: National Income and Product Accounts: Calendar-Year Basis

Year	Federal Deficit	Year	Rinfret Associates Deficit Projections
1973	-5.6	1984(e)	-165.0
1974	-11.5	1985(e)	-159.0
1975	-69.3	1986(e)	-191.0
1976	-53.0	1987(e)	-227.0
1977	-45.9	1988(e)	-268.0
1978	-29.4	1989(e)	-314.4
1979	-16.1		
1980	-61.2		
1981	-64.3		
1982	-148.2		
1983	-178.6		



Sources: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, "National Income and Product Accounts", Table 3.2. All projections (e) by Rinfret Associates, Inc.

PART THREE: WHERE ARE WE GOING?

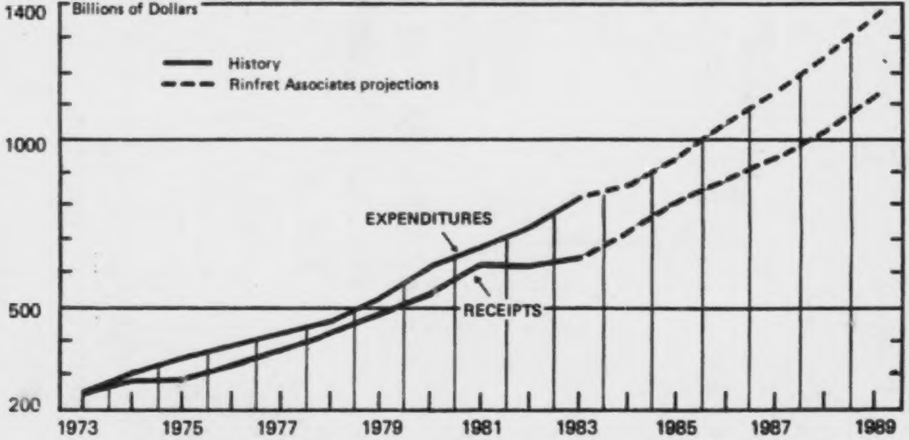
Case 2: The U.S. economy achieves what Rinfret Associates regards as its potential for the 1984-89 period.

- This assumes that the real GNP will grow at a compound average annual rate of 5.5 percent with inflation at 3.5 percent per year.
- This assumes that Federal expenditures will grow at an annual rate of 9.6 percent, which is the average annual growth rate of the past four years.
- In this case, Rinfret Associates projects the resulting Federal receipts and expenditures as follows:

Billions of Dollars: National Income and Product Accounts: Calendar-Year Basis

Year	Federal Receipts	Federal Expenditures	Year	Federal Receipts	Federal Expenditures
1973	258.6	264.2	1984(e)	702.2	867.2
1974	287.8	299.3	1985(e)	802.6	950.4
1975	287.3	356.6	1986(e)	875.0	1041.6
1976	331.8	384.8	1987(e)	953.6	1141.6
1977	375.2	421.1	1988(e)	1039.4	1251.2
1978	431.6	461.0	1989(e)	1133.0	1371.4
1979	493.6	509.7			
1980	540.9	602.1			
1981	624.8	689.1			
1982	616.7	764.9			
1983	641.1	819.7			

FEDERAL RECEIPTS AND EXPENDITURES



Source: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, "National Income and Product Accounts", Table 3.2. All projections (e) by Rinfret Associates, Inc.

PART THREE: WHERE ARE WE GOING?

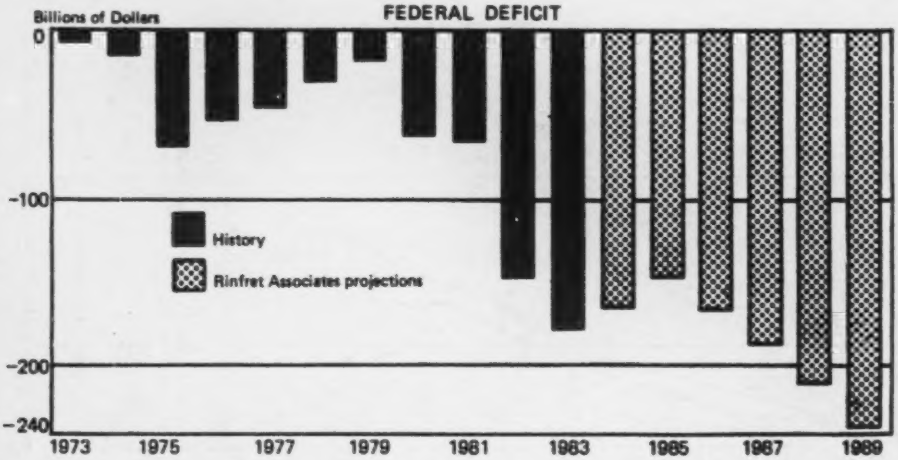
Case 2: The U.S. economy achieves what Rinfret Associates regards as its potential for the 1984-89 period.

- This assumes that Federal spending will continue to grow at the 1980-84 pace of 9.6 percent, but with a real GNP growth rate of 5.5 percent and an inflation rate of 3.5 percent per year.

- In this case, Rinfret Associates projects that the deficit will be smaller than it would have been with a 4 percent real GNP growth rate, although still high by historical standards. The resulting Rinfret Associates deficit projections are as follows:

Billions of Dollars: National Income and Products Accounts, Calendar-Year Basis

Year	Federal Deficit	Year	Rinfret Associates Deficit Projections
1973	-5.6	1984(e)	-165.0
1974	-11.5	1985(e)	-147.8
1975	-69.3	1986(e)	-166.6
1976	-53.0	1987(e)	-188.0
1977	-45.9	1988(e)	-211.8
1978	-29.4	1989(e)	-238.4
1979	-16.1		
1980	-61.2		
1981	-64.3		
1982	-148.2		
1983	-178.6		



Source: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, "National Income and Product Accounts", Table 3.2. All projections (e) are by Rinfret Associates, Inc.

PART THREE: WHERE ARE WE GOING?

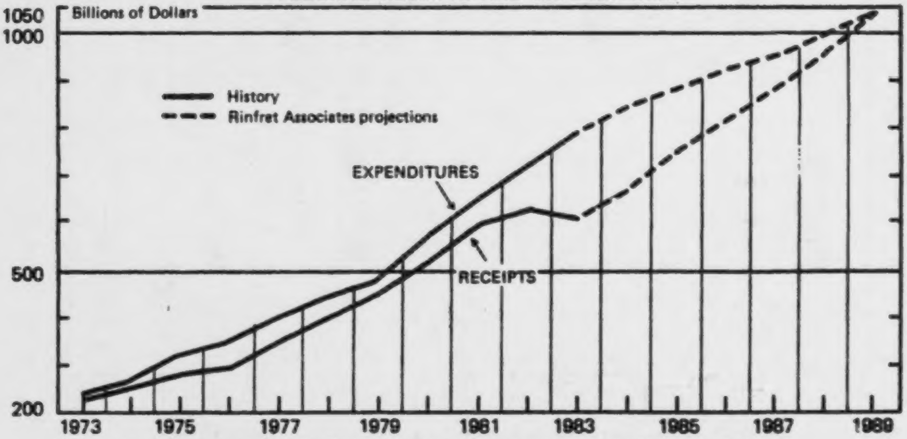
Case 3: The GNP grows at a rate of 8.3 percent per year, as projected by the Congressional Budget Office (CBO).

- The CBO assumes that Federal receipts will increase at a compound annual average rate of 9.1 percent.
- In this case, if we are to balance the budget by 1989, Rinfret Associates (RAI) projects that Federal expenditures will have to increase at a rate of only 4.3 percent per year, versus the CBO's projected 9.1 percent rate of increase per year.

Billions of Dollars: Unified Federal Budget, Fiscal-Year Basis

Year	Receipts With CBO Projections	Expenditures With RAI Projections
1973	232	247
1974	265	270
1975	279	324
1976	298	364
1977	356	401
1978	400	448
1979	463	491
1980	517	577
1981	599	657
1982	618	728
1983	601	796
1984(e)	673	845
1985(e)	751	888
1986(e)	811	924
1987(e)	881	963
1988(e)	965	1,000
1989(e)	1,042	1,042

FEDERAL RECEIPTS AND EXPENDITURES



Sources: Revenues projections (e) from Congress of the United States, Congressional Budget Office, The Economic and Budget Outlook: An Update, August, 1984, Table III-2, page 56. Expenditures projections (e) by Rinfret Associates, Inc.

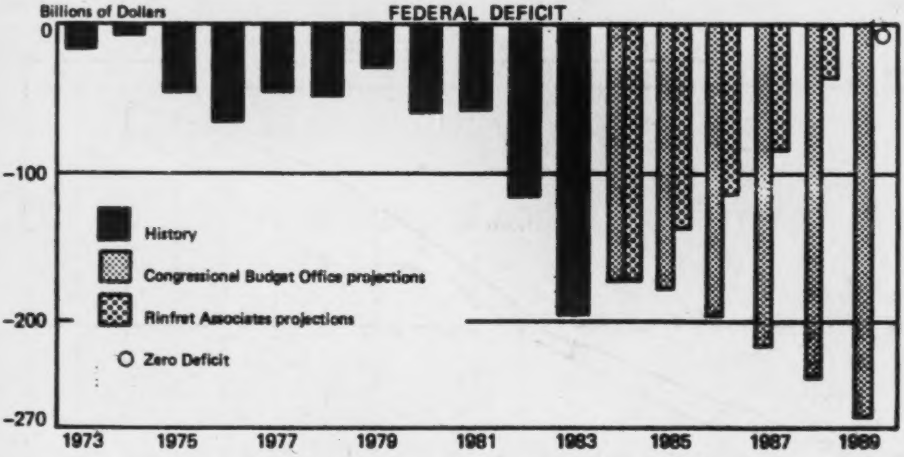
PART THREE: WHERE ARE WE GOING?

Case 3: The GNP grows at a rate of 8.3 percent per year, as projected by the Congressional Budget Office (CBO)

- In this case, if U.S. receipts increase at the 9.1 percent annual rate projected by the CBO, but expenditures increase at the 4.3 percent rate projected by Rinfret Associates, the Federal budget will be balanced by 1989. The Rinfret Associates (RAI) and CBO deficit projections are as follows:

Billions of Dollars: Unified Federal Budget, Fiscal-Year Basis

Year	Deficit With CBO Projections	Deficit With RAI Projections	Year	Deficit With CBO Projections	Deficit With RAI Projections
1973	-15	-15	1984(e)	-172	-172
1974	-5	-5	1985(e)	-178	-137
1975	-45	-45	1986(e)	-195	-113
1976	-66	-66	1987(e)	-216	-82
1977	-45	-45	1988(e)	-238	-35
1978	-49	-49	1989(e)	-263	0
1979	-28	-28			
1980	-60	-60			
1981	-58	-58			
1982	-111	-111			
1983	-195	-195			



Sources: Deficit projections (e) from Congress of the United States, Congressional Budget Office, The Economic and Budget Outlook: An Update, August, 1984, Table III-2, page 56, and from Rinfret Associates, Inc.

Chairman ROSTENKOWSKI. Mr. Rinfret, do you have any recommendations as to what area of taxation should look at to raise revenues.

Mr. RINFRET. Well, as you very well know, my doctorate was in political economics, and I always felt the word "politics" came before economics in my arena. I think that is a political decision.

I think many of these decisions that are made by many advocates of tax laws, in fact, are making statements of ideology rather than economic fact. It is very difficult to prove most theories of taxation or lack of taxation. But I would make one suggestion to you.

And I make this not as an economist, but as a citizen.

I find one thing which puzzles me. Why do certain sectors of the American economy pay no taxes at all, and why is the burden of an American system such that some companies are able to pay zero taxes year after year and some indivdiuals are able to pay zero taxes year after year.

The problem with the tax situation is very simple. And I have testified on this before you before and over the years. Once you build a tax incentive into the system, and you have built so many incentives now into this tax structure that it is a Christmas tree lighted up with candles and globes and bulbs and bobbles of every kind, once you build it in, and you start pulling them out, you adversely affect that economy.

If you pull the investment tax credit, for example, subject to on again/off again over the last 15 years, you pull that, you have an adverse impact on capital investment. I don't think there is any question about that.

You change the depreciation laws, you have an adverse impact in capital investment. You pull some of the tax shelters, you have an adverse impact on capital investment. I very frankly think in most cases you are stuck.

Your tax base is eroding as I have indicated to you in the testimony I have given you. It is eroding on corporations and on individuals. More and more of the income structure of the United States is getting out of the tax base.

The corporate taxes, as a percent of total tax, has gone from 40 to 25 percent. It is easy to say they are not paying enough taxes. We don't know enough to be able to say that if we are honest, because they are making the biggest capital investments ever made in the history of the United States.

If we look at the individual tax base, it is steadily eroding. More and more income is nontaxable or subject to deductions.

And I suggest to you that once you start as we do all the time manipulating our tax structure, we have adverse economic impact on the economy. And so the only suggestion I would offer you, without going into any great detail, is that I find it objectionable, not as an economist, but as a citizen that people can avoid paying any taxes whatsoever in a society that not only needs the revenue, but where at least we ought to pay for the police.

Chairman ROSTENKOWSKI. Thank you.

Mr. Conable will inquire.

Mr. CONABLE. I have no questions. Thank you, Mr. Rinfret. I remember you being before this committee many times in the past. Glad to see you back.

Mr. **Rinfret**. Thank you, sir.

Chairman **Rostenkowski**. Mr. Archer will inquire.

Mr. **Archer**. Dr. Rinfret, it is always a pleasure to have you before our committee. You bring a refreshing sort of an insight, particularly for an economist. I was looking at some of your charts in your testimony, in your complete testimony, which I thank you for abbreviating, and I notice that you show where the individual income tax as a percent of taxable income for individuals has gone down and the adjusted gross income has gone down for individuals.

And I wonder to what you attribute that.

Mr. **Rinfret**. Well, No. 1, of course, as you know, there is a good part of retirement I think which does not always come under the tax structure.

No. 2, there have been increases in deductions for the people over 65 years of age, many who do continue their income stream after 65. And I think it is fundamentally due to, No. 1, the elimination of a good part of the income from people over 65 that is doing it, plus some of the increases in deductions which have been given for varying reasons including inflation.

And as a result of that, there is more and more income escaping from taxable income stream. Again, it gets back to the exemptions we keep making to the tax laws.

You put in ERISA. Then you put in the Keogh. Then you put in the IRA. I must say as a taxpayer I love you. I think the most magnificent thing in the world—last year legitimately and under the tax laws of this country, I was able to put away more than $30,000, free tax dollars, not countable in my income, into a retirement plan. If I don't take advantage of it, I am a fool.

But when I look at the amount of money I can deduct before I even start to consider my tax payment, I fainted, but mainly from pleasure. But that is what you did for me.

I thank you for it.

Mr. **Conable**. We will get you later.

Mr. **Rinfret**. That is OK. I don't think that is so unfair. But the point is you have given me these deductions, I maximize them that the law allows me to, I make changes in my personal financial affairs to come under the law. And I think there is one thing that everybody forgets very candidly in the tax structure. It is very simple.

There are 240 million Americans out there, and I think they can outsmart this Congress any day of the week if they really try it, and I think they do outsmart you.

I don't know how many thousand accountants we have got. We have got hundreds of thousands of accountants and lawyers. They have more angles than I ever dreamed of.

And this is what is really beating you every time you make a change in the law, the IRA and the Keogh. I will give you an illustration.

My wife is a member of my company, a stockholder. My tax accountants say "take her off the payroll." I said, "Why? She works." "Take her off the payroll and make her a director. Pay her the same amount of money as a director. Now she can take that money and put it under a Keogh or IRA plan and it is nontaxable income."

And I said, "I won't do it, it is immoral." He said, "Well, if that is the way you want to feel about it. But you know you are just missing a great tax deduction."

I said, "No, it is immoral." I did not do it. My accountant said, "You are crazy." But that is the kind of thing I think is going on in this country. I don't blame people.

I blame the law for permitting it. The only estimates on the Keogh plan and the deduction for retirement were totally underestimated by the Treasury to a startling level of—actual deductions were about 10 times what the Treasury estimated the deductions would be.

What you provide is incentives for people to find ways out of paying taxes and they are pretty smart.

Mr. ARCHER. Dr. Rinfret, you mentioned in your testimony restraint in spending growth and an increase in the growth of tax revenues and you also included the possibility of some new taxes at an appropriate level.

Now, what would you say is the range of increased tax revenues that this economy could absorb in the next year, just looking at a 1-year frame, without being counterproductive to the economy.

Mr. RINFRET. I think this committee has had experience on it. I have been here before Mr. Conable before and the chairman before. I think we put on a ten-percent surtax, and it did not kill this country. We managed to survive 10 percent.

I think if you get much above 10 percent you begin to hit very deep psychological limits that impact this economy. I think we could raise our taxes 10 percent, put a surtax on or surcharge, to try to get this deficit down.

I think we could absorb that without any great economic impact. When you start getting above that I think you start to hurt the system. I have seen this committee do that before and rather successfully and got the revenue. And the economy survived it and forged ahead.

My answer to you, Congressman Archer, would be probably 10 percent, and then after that you start to hurt.

Mr. ARCHER. Assuming everything else being equal, that we have done as much as is possible politically on spending restraints, and we have to face the choice of a deficit or a tax increase, would you feel we would be better off with something in the parameters of your 10 percent rather than doing nothing at all and letting the deficit stay there?

Mr. RINFRET. Well, let me talk about, if I may, and answer that question—and I hope this is not an excessively long answer to that question. Let me tell you what I think you could do for this country.

I believe this Congress could go toward a balanced budget in 4 to 5 years. You notice I said "go to." If we can change the perception of the people and the financial community, which is critical—if we could change that perception, that we will aim toward a balanced budget, we will get that deficit down, we are determined to do that.

I will give you my estimate of what the prime rate would be in 1988 and you will, I am sure, think I am stark, raving mad and belong to the loony bin. I think this country could see a balanced budget by 1989, which, as I said, I define as plus or minus $20 billion.

I think the prime rate in this country would be somewhere between 6 and 7 percent. It is now 12¾. I think the mortgage rate would be 8.5. And I think you would turn on in this country the biggest economic expansion in our entire history, including the best years that we have ever had, namely, from 1962 to 1966 under President Johnson.

I think you would see prosperity in this country with a dropping of the deficit, a dropping of the interest rate to such levels that you would not believe it after you get there—you would look back and say it did not happen.

Now, have we done some of that?

Yes, we have. But we cannot maintain this kind of an economic pace with 12.5 percent on the prime rate.

Now, let's turn it around. There is no question that this system works on tax breaks. The tax incentives are a major part of the system. If you try to balance this budget by tax increases, you will impact this economy so much you will send it into another very deep recession. No question. If it takes 1 year, 2 years to do it, it doesn't matter.

People anticipate. They see what is coming. They plan ahead of time. If you came with a 10-percent tax increase, in my judgment, what you would be saying is we are serious about this, we are going to try and do something—10 percent is not going to kill anybody. And I believe that very strongly. And it will be a downpayment on trying to achieve a balanced budget, and then combine that with some control over spending—and I notice you said you don't think you can do anything there.

Mr. **Archer**. I said assuming we have done as much as we can politically, which will never be enough to satisfy me.

Mr. **Rinfret**. Even if you have done as much as you can to hold down the rate of spending, I will guarantee that your deficit in 1989 will be somewhere above $350 billion and you will not have high economic growth. I remind you, with all due respect, in the last 4 years we have had 3 years of recession and one of economic expansion, and I think it came out of interest rates courtesy of the Federal Reserve. If you maintain this level of deficits, you will maintain this level of interest rates and you will see housing decimated in 1985.

Chairman **Rostenkowski**. Mr. Crane will inquire.

Mr. **Crane**. Thank you, Mr. Chairman.

Dr. Rinfret, what percentage of our GNP is the National Government consuming to date? I saw last year it was over 24 percent. Is that correct?

Mr. **Rinfret**. It is trending down because the economy is moving up. It is below 24 percent, between 23 and 24, the Federal Government alone. That does not include State and local spending.

Mr. **Crane**. The reason I asked that is back in 1973, as I recall, it was 19 percent. It got up to 23 or 24 percent in Carter's term and it was President Reagan's objective to try to get it to that 19-percent range again. In your best scenario, by the year 1989, assuming that we went along with your recommendations on the surcharge and spending restraint, what percentage would you project it to be by 1989?

Mr. **Rinfret**. Something on the order of below 20 percent. Let me remind you, I think the Americans lose their perspective on this country. This is the biggest economic system ever known in the history of the world. At $3.6 trillion, we are more than double the Soviet Union. We are approximately three times that of Japan, but much more importantly, if you will look at those numbers, Federal spending in the United States today, using the first quarter 1985 projected rate, figure this: Federal spending alone in this country by itself is 75 percent bigger than the entire gross national product of France, double the entire gross national product of the United Kingdom, 33 percent larger than the gross national product of Western Germany, and then we wonder why it is having an impact on interest rates.

You have usurped, if I may use that phrase, the entire gross national product of the United Kingdom and doubled it and we call that Federal spending. When you look at it in those magnitudes, the sheer mass of this demand for money, for example, a $180 billion deficit, the deficit alone exceeds the gross national product of any country in the world with the exception of ten countries.

Admittedly, we are the biggest country in the world, but it gives you an idea of the impact of lowering that deficit and turning that money loose into the private sector.

As I said before, if you got that budget deficit down to something approaching equilibrium, I think we would see 4 economic years in this country that we have never seen in the postwar. I think this country is poised for an economic explosion on the upside. We saw it in the first and second quarter. No one said we could do that. We did it. We have turned loose something in this country. We have got a drive. We are reacting to competition and technology. Get the interest rates down and you turn on the construction industry and you turn on the housing industry, the appliance industry, the furniture industry, the textile industry, the carpeting industry and you will see an economy recover at the rate of between 5 to 6 percent real growth per year.

That alone, our increment of 5 percent a year, is $300 billion. That is 50 percent of the entire production of France just as an increment to this society.

Mr. **Crane**. Dr. Rinfret, it is not that I question your scenario. I think you are on target. What troubles me is before I came to this body, Milt Friedman said, "Don't vote for increased taxes because they are no longer worrying about the magnitude of the budget. The only thing that scares them is the magnitude of the deficit." And the concern I have based on past experience, TEFRA is a classic example, $3 spending reduction for every dollar increase in taxes—we actually increased spending for every dollar of taxes that we raised. That is what I find disturbing about the realities of the Congress of the United States. I don't see the discipline when it comes to biting the bullet on holding down at least the rates of spending increase below growth in the economy.

If we could do that, there is a reasonable way out of this, it seems to me, and I think your proposals are excellent. I am concerned, realistically speaking, what the Congress is apt to do.

Mr. **Rinfret.** What can I say to you, Congressman? You pass laws in Congress. You do no economic evaluation of those laws. The estimates of spending requirements on those laws is almost ludicrous in most cases. The amount of revenues you always estimate you are going to raise by taxes are always too high. The amount of spending that you project as a result of a spending bill are always too low. It is always in the direction of spending out running—I think I was the first economist in the United States to say that our Federal deficit would get up to $150 billion. When the Federal Government itself was projecting $78 billion, everybody thought it was ludicrous. I just took the nines and drew a straight line. And the way spending was going, I said, knowing Congress, it will keep right on going that way, and knowing the private sector's ability to get out of paying taxes, that will keep going down relatively speaking, and I gave you a $150 billion deficit.

You always underestimate spending. I used to have a rule years ago—the rule used to be that whatever the President proposes for a budget, I added $20 billion to his spending figure, and later on, of course, I was a piker because it became $30 billion, $40 billion, and $50 billion. But you add things on all the time.

We have taken on obligations—study your history in medicare projections, your accuracy in medicaid projections, your accuracy in Keogh plan projections. You may say, "Have people in your profession done much better?" No. The laws are so complex—I will tell you a story about my mother. She lived until she was almost 92, within a week of being 92, and my mother was a brilliant woman, a fabulously poweful woman, read everything, understood this world beautifully. My mother went on Social Security because my father died when mother was 53.

When inflation really started to recover in this country around 1968, mother said to me, "Peter, I love inflation." I said, "Mother, that is disgusting." Mother said, "No. I love inflation. It is the most wonderful thing that has ever happened to me. The Government sends me this enormous check every 6 months. I don't need that money. I just save it, buy presents for the grandchildren, but inflation is wonderful. The more the inflation, the bigger the money I get from the Government."

Mother lived from age 53 to 91⅞ on Social Security and we kept raising her checks every year. She applauded you—the more inflation that you got and the more spending, the happier you made her.

I don't say that is representative of America—you are spending at the rate of 10.1 percent per year compounded.

I am a consultant to the private sector. We know something in the private sector. When you are in the red, you cut the spending. And if you want to keep borrowing, you are going to go bankrupt. In the private sector, if you wanted to see the blood run in this country—how many people in Congress realize that we had 27 percent unemployment in Toledo? American industry was hemorrhaging. I have one client who went from $1.2 billion net worth to $300 million in 3 years. He blew 50 years in 3 years. How did he survive—and he is, incidentally, surviving, barely. He just slashed—I know you can't, but you can stop writing more spending bills. Every time we turn around there is more spending.

It is a political decision; you are responsible. It is easy for me to advise you. I am not responsible; you are. But I know keep on doing what you are doing and you will have a $350 billion to $400 billion deficit in 5 years as sure as God made green apples.

Mr. Crane. Thank you, Mr. Chairman.

Chairman Rostenkowski. Are there any further questions?

Thank you, Mr. Rinfret. The committee stands adjourned.

[Whereupon, at 2:10 p.m., the hearing was adjourned, to reconvene at 10 a.m., Wednesday, September 26, 1984.]

TAX REFORM AND DEFICIT REDUCTION

WEDNESDAY, SEPTEMBER 26, 1984

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met at 10:25 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

I want to thank you gentlemen for joining us this morning.

I dare say you recognize the difficult problems that will confront this committee in 1985. These are issues of great concern.

We have received the testimony of several witnesses yesterday. What we are trying to do this morning is gather information, pick the brains of some of the best minds in the country. We look forward to a lively discussion.

I want this to be as free flowing an exchange as possible. At the conclusion of your individual testimony, I want to encourage you to engage in a dialog with our members. I am not concerned with the time that such an exchange might take.

Mr. McDaniel, if you would like to start, you may proceed.

STATEMENT OF PAUL R. McDANIEL, PROFESSOR OF LAW, BOSTON COLLEGE LAW SCHOOL

Mr. McDaniel. Thank you, Mr. Chairman.

I appreciate the kind invitation to appear before the committee once again.

I will in these initial remarks simply summarize the written statement which I have submitted to you.

Chairman Rostenkowski. Your testimony will be included in the record in its entirety.

Mr. McDaniel. Thank you.

In your letter you requested that I compare the legislation introduced by Representative Kemp and Senator Kasten, the Fair and Simple Tax Act, the "FAST" tax proposal, and the "FAIR" tax proposal introduced by Senator Bradley and Representative Gephardt. In addition, your letter requested me to comment generally on the impact of tax expenditures in light of those two proposals.

With respect to the first item, the comparison of the FAIR and FAST tax proposals, the two bills generally share a common approach. That is, they adopt an approach that has traditionally been referred to as base broadening through the elimination of numerous special exclusions, deductions, and tax credits.

And each bill also approaches the quite distinct question of what rate structure we should have by a general rate reduction and lowering of marginal rates, accompanied by a reduction in the number of brackets.

With respect to the tax rates, there is, of course, no single set of rates which is normative for an income tax system. The design of the rate structure is to be arrived at by considering broad political objectives, the amount of revenue required, the taxation of different units, such as married persons and single persons, the effects on work and savings incentives, and the like.

Each of the proposals appears to be heavily influenced by proposals for a so-called flat tax, but in fact each has a progressive rate structure. Each bill contains four separate rate brackets.

The FAST tax proposal provides a zero rate of tax for income between zero and $3,500, a 20 percent rate from $5,500 to $45,800, a 28 percent rate from $48,500 to $153,000, and then drops back to a 25 percent rate.

The FAIR tax proposal, on the other hand, provides a zero rate up to $6,000, then 14 percent up to $40,000, then 26 percent to $65,000, and 35 percent above $65,000.

So each bill does adopt a progressive rate structure despite the influence of so-called flat tax proposals.

The rather peculiar rate structure embodied in the FAST tax proposal in which the rates go from 20 to 28 and then back to 25 percent is a function of the fact that it contains a provision allowing a special deduction of wage income equal to 20 percent of the Social Security wage base. That deduction is then phased out at a 12.5 percent rate, and, in the phaseout range, a 28 percent marginal rate is in effect applicable rather than the nominal 25 percent rate. If this proposal is adopted, I assume that tax shelter promoters in the future will target all of their offerings to those in the 28 percent bracket.

In both proposals, a single set of rates applies to capital gains as well as to ordinary income, although the FAST tax proposal does adopt an indexation system for capital assets. From the standpoint of tax simplification in the area of capital gains, the FAIR tax proposal is considerably the simpler. It eliminates all the code provisions that are necessary to distinguish between capital gains and ordinary income. It thus would allow us to get rid of some of the most complex provisions in the code in the corporate and individual income tax, and with respect to partnership taxation.

The FAST tax proposal reintroduces a lot of that complexity by its proposal to index basis. That proposal, of course, has to be given careful consideration in light of the testimony that this committee received during the period 1976 to 1980 with respect to carryover basis. In that debate, we were continually assured that taxpayers did not have adequate records to enable us to carry out a carryover basis rule. The basis recordkeeping for adjustments for inflation are considerably more complex. I suppose that those groups will be equally concerned about that recordkeeping requirement here. On the other hand, if the inflation adjustment were adopted, it would be then a very simple matter to introduce capital gains at death or carryover basis.

On other matters of the rate structure, I leave it to the economists to comment further on the effects on work and saving. I would simply note that, as I read the literature, the rate reductions that are provided in both bills would have at best a speculative effect on work incentives. As to whether the reductions would provide an increase in aggregate savings, again, as I read the literature, although economic studies have attempted to show a correlation between reduction in rates and increased savings, I think the consensus is that the theory may be true, but it is not yet conclusively established.

Whether the proposed rate structures are more fair or equitable than the present rate structure is a difficult matter to determine. For example, in the FAIR tax proposal, a wage earner with $10,000 of income is subject to exactly the same marginal rate as the person making $40,000 a year. I think there may be some people, myself included, who would think that the person making $40,000 a year in fact should be in a higher marginal rate bracket than the person making $10,000 a year. That is to say, it is not automatically to be assumed that the adoption of fewer but wider brackets necessarily will produce a fairer rate structure in the eyes of everyone. But again this is a value judgment which members of this committee will have to make.

With respect to the tax base, which is quite a different thing, both bills broaden the base considerably, and in a sense achieve greater simplicity and equity by virtue of that fact. In the case of some of the more important items, the FAIR tax proposal with respect to depreciation seems to me to be superior to the FAST tax proposal, because the FAIR tax proposal does move us closer to economic depreciation than we are at the present time. That measure, when coupled with the elimination of capital gains, should go a long way toward cutting back on the scope of tax shelter activities, in itself a result which would achieve a major simplification in the tax system.

With respect to the impact of tax expenditures, I would like to direct my comments to the implications that that analysis has for the strategy of proceeding with what is traditionally called tax reform or tax simplification. There can be little doubt that each bill in its base broadening aspects achieves a great deal of tax simplification and would certainly be more equitable in the traditional senses of these terms.

Tax expenditure analysis, however, requires that we look at these two measures, and indeed any comprehensive tax reform measure, in quite a different fashion.

There are presently, as you know, over 100 tax expenditure programs employed in the United States and these, in the aggregate, total about one-fourth of total Federal tax and direct spending. The primary impact of both bills, in their base broadening proposals, is on the tax expenditure provisions. Almost all of the provisions that are repealed are tax expenditures.

Now, when one looks at these programs as spending programs, a somewhat different picture emerges. The tax expenditure concept, as you know, posits an exchange of checks between the taxpayer and the Government. The taxpayer in effect writes out one check, which we might call his economic tax check, equal to the tax liability he would have if there were no special provisions. He gets back from the Treasury a subsidy check, which is the sum of all of the tax subsidies for which he qualifies. The net amount is what he sends in to the Government. We don't bother with sending checks back and forth. But the net effect is the tax payment that goes into the Government is simply the net of those two numbers.

Now, with this framework, it becomes apparent that what these bills are doing and what Congress is doing when it repeals tax expenditures is not raising taxes, it is cutting spending. It is cutting spending that is run through the tax system. That analysis is somewhat contrary to the popular view, but economically that is what is occurring.

When Congress eliminates any spending program, it has three choices as to what to do with the resulting revenue. It can reduce rates, it can reduce the deficit, or it can direct the revenues to some other spending program. And exactly that same set of options confronts Congress when it reduces spending through the tax expenditure mechanism.

The two bills proceed on the assumption, in effect, that all revenues from reducing tax spending ought to be funnelled into rate reductions. That, of course, is one option. But it is not the only option. It is important to keep in mind that, just as cutting direct spending programs would allow Congress to devote the revenues to reducing the deficit or to funding other programs, the same options confront it when it repeals tax expenditures.

Tax expenditure analysis requires that we look at each of these tax expenditure programs and analyze them in the same way we would a direct spending program. That is to say, is there a need for the program? If so, what is the appropriate level of funding for it? Is it a cost effective program? And, if it should be repealed, should it be replaced by a better designed direct program or should the revenues go to deficit or rate reductions?

Proponents of existing tax expenditures focus very hard on the first two questions. They assert that there is an overriding need for Federal support of a given program. Proponents of repeal tend to focus on the latter two questions, that the programs are deficient in failing to meet objectives and the like.

But the point is that both proponents and opponents are focusing on these programs as spending programs. The problem with traditional arguments for repeal of tax expenditures—tax simplification and tax equity—is that they are answers to a question that no proponent of the tax expenditure is asking.

I have never run into a taxpayer who has said that he would be prepared to give up his tax subsidy in order that the Internal Revenue Code could be simplified. And this is the basic problem. Tax simplification and tax reform are not answers to spending questions, they are answers to quite different questions.

To argue, for example, that we need tax simplification simply does not tell us that we ought to eliminate all the energy tax credits; that is, the need for tax simplification does not demonstrate that there is no need for Federal energy subsidies, which are now provided through energy tax credits.

With this background in mind, what do the proposed bills do to tax expenditures? In their rate reductions, they reduce spending through the tax system automatically and drastically. Under the FAIR tax proposal, all itemized personal deductions can be taken only against the 14 percent bracket. That means that the charitable contribution deduction, for example, is worth only 14 cents on the dollar to every contributor instead of the present maximum of 50 cents on the dollar. Thus, all Federal support for charity is automatically reduced by the rate reduction. The same thing is true of the FAST bill as well. It may be that Federal support of charitable organizations ought to be reduced, and it may be that 14 percent is the right level of every donor's contribution, but I suspect that you may hear from charitable organizations that that is not the case. And one does have to be prepared to respond, I think, in the terms in which these organizations are going to be raising the question. At least as I have seen the discussions of these two bills, they really don't make a response in those terms.

The same analysis, of course, applies with respect to home mortgage interest deductions and property taxes. It may well be there is no need for these subsidies or that they should be drastically cut. I am not sure that the automatic cut provided in these bills is the one that Congress would settle upon if it directly faced the question. And I am suggesting that it is going to have to face directly the question regardless of the approach adopted.

In many areas, tax expenditiures provide far greater Federal spending for particular items in the budget than do direct spending programs. The energy credits are one example. It may be that we want to stop Federal funding of exploration for and development of alternative fuel sources. There may not be a need for any Federal cost-sharing support. But I think it is a question to which Congress ought to have an answer and the answer to that question is not provided by the terms "tax equity" or "tax simplification."

As a final point, I should also note that the words "tax equity" in the context of tax expenditures have quite a different meaning than is traditionally meant by those terms. In the context of tax expenditures, the only tax equity issue is whether the tax expenditure itself is treated properly for tax purposes. And some tax expenditures are. For example, some of our tax credits are required to be included in taxable income, either directly or indirectly. There is no tax equity issue presented by those provisions. They are treated exactly as direct expenditure programs are treated for tax purposes. There are spending equity issues involved, that is, do we have a fair distribution of the benefits viewed as spending programs, but they are not tax equity issues.

As another example, many of the tax expenditure programs are interest-free loans provided through tax deferral. The only tax equity issue is the fact that we don't include in income the value of the interest-free loan element. I hesitate, after the 1984 act, to say we ought to apply the original issue discount rules or below-market loan rules to loans run through the tax system. But conceptually that is the correct answer from a tax equity perspective.

My message is obviously not that we ought to keep all tax expenditures in the code. But I do believe that tax expenditure provisions have to be addressed in the terms on which they are supported. They are supported as spending programs. Nobody argues that we need energy tax credits because we are better able thereby to define income. They are there because we need an energy program, it is asserted. And I suggest that the strategy of achieving comprehensive tax reform must address that fundamental fact. Answers must be provided in spending terms to those tax expenditure programs that are destined for repeal or substantial reduction.

Failure to do that, I am afraid, will lead us, in terms of tax simplification, to the situation, to paraphrase Senator Russell Long's famous dictum, "Don't simplify you, don't simplify me, simplify that fellow behind the tree." I think the problem he points up is that we have to deal with these tax provisions in spending terms, not in traditional tax simplification or tax equity terms alone.

Chairman ROSTENKOWSKI. Thank you, Mr. McDaniel.

[The prepared statement follows:]

STATEMENT OF PAUL R. McDANIEL, PROFESSOR OF LAW, BOSTON COLLEGE LAW SCHOOL

INTRODUCTION

I appreciate the invitation of the Committee to appear and discuss the issues presented by proposals for fundamental restructuring of our income tax. I am Professor of Law at Boston College Law School and Of Counsel to Hill and Barlow, Boston, Massachusetts. In my testimony today I am not representing the interests of any particular group or client.

The Chairman has asked me to address specifically the impact on individuals of the legislation introduced by Representative Kemp and Senator Kastan, the Fair and Simple Tax Act (the "FAST" tax proposal) and that introduced by Senator Bradley and Representative Gephardt, the Fair Tax Act (the "FAIR" tax proposal). In addition, I have been requested to discuss the range and effect of tax expenditures.

In the first section of my statement, I will discuss and compare the FAST and FAIR tax proposals in light of their avowed objectives to achieve greater tax simplification and tax equity and to provide more efficient and effective incentives for work and savings. In the second section, I will examine these proposals from the perspective of tax expenditure analysis.

I. COMPARISON OF THE FAST AND FAIR TAX PROPOSALS

In very broad terms, the FAST and FAIR tax proposals share a common approach. Each proposal adopts what has traditionally been referred to as a "base-broadening" approach through the elimination of numerous special exclusions from income, deductions and tax credits. Each bill also approaches the quite distinct question of tax rates by applying all of the revenues gained from the base-broadening revisions to reduction in the marginal rates presently applicable to individuals and the number of rate brackets. It is helpful to discuss separately the issues posed by the proposed changes in tax rates and the issues posed by the proposed changes in the tax base.

A. The Tax Rates

There is no single set of rates which is normative for an income tax system. Instead, the design of a rate structure is a matter to be determined from broad political objectives such as the amount of revenue required, whether single persons and married persons should be subject to the same or different rates, whether adults with dependent children should be subject to the same rates as adult taxpayers without dependent children, etc. The answers to these questions rest on an assessment of broad value judgments rather than on tax theory.

Although each proposal has been heavily influenced by calls for a so-called "flat" tax, each adopts a progressive rate structure. Each contains four rate brackets, although the rates themselves and the levels of income to which they apply are different. The FAST tax proposal provides a zero rate of tax for taxable income between zero and $3500 (through a combination of personal exemptions and a standard deduction); a 20% rate from $5500 to $45,800; a 28% rate between $48,500 and $153,270; and a 25% rate above $153,270. The FAIR tax proposal, on the other hand, provides a zero rate from zero to $6000; a 14% rate from $6000 to $40,000; a 26% rate from $40,000 to $65,000; and a 30% rate above $65,000.[1]

The rather peculiar rate structure that is embodied in the FAST tax proposal is a result of a provision which grants a special deduction equal to 20% of salary income up to the Social Security wage base. As a result, the real marginal tax rate for incomes under the Social Security wage base is about 20% (rather than the 25% rate specified in the nominal rate structure). Above the Social Security wage base figure, the special deduction is phased out at a 12 1/2% rate. Accordingly, in the phase-out range, the marginal tax rate is 28%, rather than the 25% nominal rate.

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[1] Burton, Major Tax Reform Proposals at a Glance, 23 Tax Notes 1095, 1096 (1984).

In the case of capital gains income, the FAST tax proposal, after a 10-year transition period, would impose its maximum 25% rate and the FAIR tax proposal would impose its maximum 30% rate.

An individual income tax that employs a progressive rate structure contains an inherent amount of complexity. This complexity results from the fact that taxpayers will be in different brackets in different years. Rules thus are required which prevent taxpayers from shifting income from higher tax years to lower tax years and by shifting deductions from lower tax years to higher tax years. By adopting only four rate brackets and by having those rates apply to very broad ranges of income, both proposals will mitigate the complexities inherent in a progressive rate structure. But it is important to recognize that neither will eliminate those complexities in their entirety.

The simplification claims for the rate structure changes in both bills should not be oversold. There still would be a substantial benefit, for example, under the FAIR tax proposal, to shift income from a 30% bracket parent or grandparent to a 14% bracket child or grandchild. As a result, all the complexities arising out of attempted assignments of income by contract, trust, corporations and other arrangements would continue under either bill.

Whether the FAIR and FAST tax rate structures are more "equitable" than the present rate structure involves a value judgment about the relative tax burden that will be borne at different income levels. For example, a married couple with $10,000 of taxable earned income will pay the same 14% marginal tax rate under the FAIR tax proposal as will a married couple with $40,000 of taxable earned income. That is not the case under the present rate schedule under which the $40,000 couple will pay a higher marginal rate than will the $10,000 per year couple. Under the FAST tax proposal a married couple with $10,000 of wage income and

and a married couple with $45,800 of wage income will each incur the same marginal rate. Whether these results are more "fair" or more "equitable" than the present rate structure is a matter for legitimate political debate. I think it is important to recognize that adopting a broad bracket to which a single rate applies will not necessarily make the rate schedule more fair in the eyes of many people. My own view of vertical equity leads me to conclude that taxpayers with $40,000 of income should incur a higher marginal rate than those with $10,000 of income. Ultimately, however, political policymakers must determine that issue, reflecting and representing as you do the values of your various constituents.

The effect of reducing marginal tax rates on work incentives and aggregate savings is a matter which has been much debated by economists. My own reading of the economic literature is that lower marginal rates have very little effect on work incentives. The question whether reduction of marginal tax rates will increase aggregate savings, as I read the economic literature, has not yet been conclusively resolved. Lower marginal rates will leave taxpayers with greater amounts of disposable income. But whether taxpayers will take that increased income and use it for personal consumption rather than for savings is a matter to which economic theory does not provide an a priori answer. Economic studies which have attempted to show an increase in aggregate savings from reduced tax rates have, I believe, not been accepted as conclusive by most economists; it is possible that the studies are correct in their assessment of the effect of reducing tax rates on the level of savings, but the present state of knowledge does not support that conclusion.

As discussed below, both bills retain preferential treatment for certain types and forms of savings. As a result, neither bill achieves economic neutrality in the choice of investment or savings opportunities facing individuals and business. To some extent, the bills retain the present incentive simply to shift savings from those forms which are not taxed preferred to those which are, but with no increase in the aggregate level of savings of investment.

In summary, both bills would appear to reduce to some degree the level of complexity inherent in a progressive rate structure. Neither bill can make any claim based on tax or economic theory that its rate structure is more "fair" than the present one. And, in my view, the economic case for reducing marginal rates to produce greater incentive to work and saving is as yet unproved.

B. The Tax Base

Both the FAST and FAIR tax proposals generate revenues for their respective rate reductions by what has been traditionally referred to as "base broadening". That is, each bill repeals numerous special exclusions, deductions and credits which are presently in the Code to achieve non-tax objectives. In this section I propose to look at the major elements of base broadening in each proposal from the standpoint of their impact on tax simplification and tax equity. The economic and other effects on those who benefit from the special provisions are taken up in section II, below.

From the standpoint of tax simplification, it is readily apparent that both bills make significant advances. But,it is important not to overstate the simplification that will be achieved. In defining the income tax base, substantial complexities would remain if either proposal is adopted. Some examples, by no means exhaustive, will illustrate this fact:

(1) Disputes will continue between the Internal Revenue Service and the taxpayer as to whether a particular expenditure is a deductible business expense or a nondeductible personal cost. That is, neither bill resolves any better than present law on which side of the line fall travel, entertainment, clothing and education costs. These

expenditures would continue to involve substantial complexity and litigation in borderline situations.

(2) Similar complexities are involved in drawing the line between immediately deductible expenses and capitalizable costs; neither bill would simplify the handling of these quite difficult problems.

(3) Because income and deductions must be assigned to the proper taxable period and because taxpayers can use either the cash or accrual method of accounting to effect that assignment, the complex provisions adopted in the Tax Reform Act of 1984 dealing with the time value of money would still be required.

(4) Under both bills, it would still be necessary to determine whether deductions attributable to nonrecourse financing are to be allowed; thus, the complexities of the at-risk rules would remain with us.

With this important caveat in mind, let me turn to examination of the major base-broadening components of the FAST and FAIR tax proposals in light of tax simplification and tax equity concerns.

1. Capital Gains. Each bill repeals the preferential treatment of capital gains and applies the regular rate structure to that form of income. (The FAST tax bill would achieve this result after a ten-year transition period.) The elimination of the distinction between capital gains and ordinary income would represent both a major tax simplification and a significant step toward greater tax equity. Indeed, no proposal that retains the present distinction can make any serious claim to tax simplification. Elimination of the preferential treatment would permit the repeal of some of the most complex provisions in our individual, corporate and partnership taxation provisions. Correspondingly, the time of tax advisors

that is currently devoted to structuring transactions to come under the golden umbrella of capital gains could be spent in economically more productive pursuits. The burden on the courts would also be reduced as litigation over what is and what is not a capital asset would be eliminated.

The FAST tax bill reintroduces complexity in the area by providing an inflation adjustment for the basis of capital assets. This provision would undo much of the conceptual simplicity noted above since definitional disputes would continue over which assets were and which were not eligible for the inflation adjustment. Any inflation adjustment provision will be quite complex in operation as taxpayers are required to maintain basis records and make annual adjustments. The Committee will recall that several professional groups lobbied vigorously for the repeal of the carryover of basis at death rule in the late 1970's. Their primary objection was that taxpayers did not maintain adequate records to establish basis. The record-keeping requirements for inflation adjustments would seem much more onerous and thus the concern of these groups must be kept in mind. On the other hand, if those concerns are mitigated when inflation adjustments for capital assets are at issue, then adoption of an inflation adjustment provision would make implementation of taxation of gains at death or carryover basis rules a relatively simple matter.

More fundamentally, there are a number of items in the tax base that are affected by inflation, for example, inventory and debt. Adoption of basis adjustments only for capital assets is simply selective tax reduction for a certain type of income. Complexity and inequity inevitably follow. If, for example, the inflation gains realized by a borrower who invests in a capital asset are not taxed, but his capital gains are inflation-proofed, we will have a different, but equally important, distortion in tax equity and in investment decisions as under present law. A country can decide either to index its tax base entirely or to index none of it; but indexation of only a part will undo much of the simplification and equity gains which would result from repeal of preferential treatment for capital gains.

The FAST tax proposal would allow taxpayers to deduct capital losses in full in the year realized and excess losses could be carried forward. This rule raises the problem that taxpayers would have an incentive to sell loss assets and retain gain assets (especially if there is no taxation at death). Consideration should be given to whether it is necessary to restrict the deduction of realized losses from capital assets to realized gains from those assets. I recognize that such a rule would retain some of the complexity generated by present law; but that complexity may be necessary so long as gains are not taxed on an accrual basis or, at least, at death.

2. Depreciation. The FAST tax proposal in general retains the ACRS cost recovery system. The FAIR tax, on the other hand, adopts a modified version of the former ADR system which is intended to bring tax depreciation closer to economic depreciation. On grounds of tax simplification and tax equity, the FAIR tax proposal is much the superior approach.

At first glance, it may appear that ACRS, with only four class lives, is the more simple system (FAIR tax propeses six classes). But this conclusion overlooks that fact that ACRS is a major element fueling the continually burgeoning tax shelter industry, an industry which is the source of enormous complexity in tax planning, tax administration and tax litigation. Economic depreciation, coupled with repeal of preferential capital gains treatment, would eliminate two of the three blocks on which tax shelters are constructed (the third block, leverage, would remain under both bills).

Even apart from the beneficial affects resulting from cutting back the scope of tax shelter activity, the FAIR tax approach would bring greater simplification for businesses as they analyze competing investment possibilities. It has been well documented by economic studies that ACRS produces drastically different after-tax yields among investments with different economic lives. The FAIR tax approach would move toward eliminating these investment distortions and the investment choice could be made on less complex and economically more sound considerations.

3. Business tax credits. Both bills repeal the investment tax credit, the various energy credits, the rehabilitation tax credit, the R & D tax credit, the targeted jobs tax credit and the ESOP credit. Major simplification is thereby achieved since the need for the ordering provisions is eliminated, tax returns would not require multiple credit computations, and the regulations and rulings burden on the IRS would be reduced. Tax equity is enhanced. But, as discussed below, repeal of these provisions is unlikely to turn on these traditional "tax" considerations.

4. Personal exemptions and deductions. Neither bill makes significant advances in the case of the various itemized personal deductions as such, either in terms of tax simplification or tax equity. Of course, since both bills raise the zero bracket amount, fewer taxpayers will be required to itemize and thus some simplification is achieved. The FAST tax proposal would eliminate the deductions for state and local taxes; FAIR tax would repeal the deduction for non-mortgage personal interest. Both bills, however, retain the major itemized deductions for home mortgage interest, property taxes, charitable contributions, and medical costs. The political considerations behind the decisions to retain these deductions are understandable, but an opportunity for significant tax simplification is thereby passed up. It is, for example, now almost impossible to predict the results of charitable contributions of many types of property without a sophisticated computer analysis.

The bills provide differing amounts of personal exemptions. The major difference is that the FAST tax proposal repeals the extra exemptions for the elderly and the blind, while FAIR tax retains them. Tax policy concerns support the FAST tax approach but, as discussed in section II, these concerns may not be determinative.

Both bills would repeal the present deduction for two-earner married couples. This deduction differs in its conceptual underpinnings from the itemized personal deductions discussed above. The two-earner deduction adjusts the burden of taxation between one-earner and two-earner couples; that is, it can be viewed as an offset to the failure to tax the value of services performed by the non-earning spouse in a one-earner couple. The present provision is too limited in the scope to achieve this objective. But, in considering its repeal, the Committee should keep in mind the fact that the deduction can be seen to perform a function quite different from other deductions for personal costs.

5. Personal tax credits. Both bills retain the earned income credit. FAST tax would repeal the child care credit; FAIR tax would retain it as a deduction against income taxable at the 14% rate. Neither the credit nor the deduction is argued for tax policy grounds and retention, repeal or modification must be considered under the analysis in section II.

6. Saving and investment. Both the FAST and FAIR tax proposals generally retain present preferential treatment for savings effected through IRA, Keough plans and corporate employee retirement benefit plans. In addition, each retains the tax-free status of interest from general obligation state and local bonds (the exemptions for industrial development bonds would be repealed). The arguments for and against these provisions must be analyzed under the criteria set forth in Section II.

C. Summary

Although the FAST and FAIR tax proposals retain a significant number of preferential tax provisions, they do represent major advances in base broadening, with concommitant benefits in terms of tax simplification and tax equity. History indicates, however, that it is doubtful whether these two bases, upon which traditional tax reform efforts have been grounded, will prove adequate to carry the political day against proponents of the provisions which would be eliminated or scaled back. And there is reason to be skeptical whether the proposed rate reductions will provide the requisite political force to overcome the objections of those individuals and industries which benefit from the provisions selected for extinction. The reasons for these reservations are spelled out in the following section.

II. TAX EXPENDITURES AND TAX REFORM

A. Introduction

The tax expenditure budget reflects the now well-established proposition that government, when it desires to provide a financial incentive or relief from hardship, can use a direct expenditure program or a comparable tax provision. There are at present over 100 tax expenditure programs employed by the United States and tax expenditures comprise about one-fourth of total tax and direct spending.

Tax expenditure analysis requires that we ask quite different questions about the proposed repeal, modification or expansion of preferential tax provisions than those posed by traditional tax reform analysis. That difference results from the different view of what occurs in the tax system when tax expenditure provisions are employed. Tax expenditure analysis starts with the view that when a taxpayer sends in a check with his or her tax return, that check in fact is a net of two separate "check" transactions between the taxpayer and the Treasury. The first check is the amount of tax liability the taxpayer would incur if tax were imposed on his economic net income (i.e., no preferential tax provisions were in effect). This we may call his "economic tax check". The second check is that issued by the Treasury which is the sum of the benefits from the various tax expenditure provisions for which the taxpayer qualifies. This we may call his "subsidy check".

We do not go through a formal "two check" process, of course, but the economic effect is the same as the taxpayer fills out his or her return and remits the net of the two checks to the IRS.

With this analytic framework, the issues posed by repeal of tax expenditures are substantially different from those raised in Section I under traditional tax policy analysis. Under tax expenditure analysis, the issues involved are spending rather than tax issues. Since virtually all the revenue gained in the FAST and FAIR tax proposals are from repeal or reduction of tax expenditures, it seems crucial to address the effects of those bills in spending terms.

Repeals or reductions in tax expenditures have the same potential effect on the budget as do repeals or reductions in direct spending programs. That is, when Congress repeals a tax expenditure, it can use the resulting revenues to (1) reduce rates, (2) reduce the deficit, or (3) fund a new or expand an existing spending program. The same is true with the revenues made available from the repeal of a direct spending program.

The assumption of both the FAST and FAIR tax proposals is that all revenue gains from repeal or reduction in tax expenditures are to be devoted to rate reductions. None are to be devoted to deficit reduction or to the funding of direct programs in the same budget area. This assumption is, of course, not unassailable and it must be recognized that the other alternatives are available to Congress.

Tax expenditure analysis also makes clear that when Congress repeals or reduces tax expenditures, it is involved only in making spending reductions; it is not involved in imposing tax increases, despite the contrary popular presumption engendered by traditional tax analysis. That is, the taxpayer's "economic tax check" remains the same when the tax expenditure is repealed; it is only his subsidy check from the Treasury which has been cut. When a taxpayer's direct subsidy is cut, we do not assert that he has thereby suffered a tax increase; he has no more suffered a tax increase when his tax subsidy is cut.

The recognition that repeals or reductions in tax expenditures involve us solely in federal spending considerations requires that we look at each of the tax expenditure provisions repealed or reduced by the FAIR and FAST tax proposals in light of the following questions:

1. Is there a need for the program?
2. If so, what is the appropriate level of funding for the program?
3. Is the program deficient in failing to meet its announced objectives at an acceptable cost?
4. If the tax expenditure is repealed, should it be replaced by a better designed direct program or should the resulting revenues go toward deficit reductions or tax rate reductions?

Proponents of existing tax expenditures will certainly focus hard on the first two questions; Congress should focus equally hard on the last two as well. But, in focusing on these questions, Congress and proponents of tax expenditures that would be affected by the FAST and FAIR tax proposals will at least be addressing the same issues. After all, no proponent of the investment credit or the extra exemption for the blind or the exclusion for employer-provided education benefits argues that these provisions are needed to define the tax base properly. They are arguing that there is a need for the federal financial assistance and that the tax expenditure route is the best method of providing that assistance. Those arguments must be squarely addressed. Tax expenditure analysis does so; traditional tax reform analysis does not.

Let me turn now to an examination of the issues discussed in Section I from the perspective of tax expenditure analysis.

B. Tax Rates

Both the FAST and FAIR tax proposals reduce marginal tax rates significantly. Both retain important tax expenditure provisions, particularly with respect to the itemized personal deductions. The amount of revenue expended through any tax expenditure provided through a special exclusion, deduction or exemption is a function of the rate structure. As a result, the rate reductions provided in both bills will substantially reduce the federal support provided through the charitable contributions deduction, the home mortgage interest deduction, and the like.

Under the FAIR tax proposal, for example, the value of a charitable contribution is 14% of the deductible gift. For donors who presently are subject to rates below 14%, this change will increase the value of the deduction; but for all donors above the 14% bracket, the portion of their donation that in effect comes from the government would be reduced. Under the FAST tax proposal, the government share of the gift generally would be 25%, but the effect is the same. Whether aggregate giving to charity would be reduced under either proposal depends on whether donors increase their own after-tax giving to pick up the reduction in the federal portion of the gift. This same analysis holds true for home mortgage interest deductions, property tax deductions, etc.

The foregoing does not suggest that Congress should avoid rate reductions because federal support for charity drops, or subsidies for home owners are reduced, or the support of those with catastrophic illness will be reduced. It does suggest, however, that Congress must recognize that, in dramatically lowering rates, it is also reducing federal support provided through those tax expenditures that are retained. It seems unlikely that beneficiaries of tax expenditures are going to be consoled by the fact that a reduction in their subsidy will provide tax cuts to taxpayers generally! Accordingly, Congress does need to address the question whether the level of support provided for charities, home owners, etc., when 25% or 14% rates are employed is the level which Congress deems appropriate. If not, it may be necessary to consider using some of the revenues gained from reducing the value of the tax expenditure to provide alternative direct program support rather than directing all of that saved revenue to rate reductions.

C. The Tax Base

1. The Goal of Tax Simplification. One of the principal tax policy advantages to the repeal of preferential treatment for such items as capital gains, statutory fringe benefits, etc., is tax simplification. As we have noted, elimination of these preferences would enable Congress to simplify the Code to a very substantial extent.

But, I suspect that proponents of preferential treatment for these items will be unmoved by the argument. Indeed, I have never met a taxpayer who was willing to give up his tax subsidy so that the Internal Revenue Code could be simplified!

For example, many proponents of preferential treatment for capital gains implicitly or explicitly recognize the tax simplification arguments advanced by traditional tax reformers. But that argument is not responsive to, or is considered less important than, the perceived need for a federal incentive to investors to provide the capital needed for an expanding economy. To address this argument, proponents of repealing the preferential treatment for capital gains must show either that no federal subsidy is required at all (the market can be expected to provide the necessary investment incentive) or that a more efficient and effective subsidy can be devised which will also simplify the tax system.

The same issue confronts the proposed repeal of the business tax credits, the statutory fringe benefit provisions, and those itemized deductions that are eliminated by the FAIR and FAST tax proposals. It is obviously true that any federal subsidy program is simplified if it is repealed. But, simplification as a justification for repeal does not really address the question of whether there is a need for some form of federal financial assistance.

It also must be remembered that every federal program must be administered by some agency or department. Switching a tax expenditure program to a direct program may produce tax simplification but the change may not produce an overall simplification in government subsidy programs. If a need for federal assistance has been demonstrated, the question is whether it is simpler to use a direct or a tax expenditure program. There does not appear to me to be an a priori answer to that question. Instead, an analysis is required of the effects of using one route versus the other in light of administrative and simplification criteria as applied to ease tax expenditure.

I share the view of many tax advisors that the tax administration system is heavily overloaded, primarily because of the existence of so many tax expenditure provisions. But our view is somewhat parochial. I would not, for example, assert that if all the tax expenditures for health care were removed from the Code and placed in HHS, there would be an overall simplification of governmental health programs. I am confident tax administration would be improved. But Congress needs to make an assessment of the broader issues of governmental administration.

It may well be that the need for simplification of the tax system overwhelms the need that may be demonstrated for any of the tax expenditures targeted for repeal by the FAST and FAIR tax proposals. But I suspect that political realities will dictate a case-by-case assessment of these tax expenditures. In these assessments, tax simplification is surely one criteria, but the criteria applied to federal spending programs cannot be ignored. If we do, we may be faced with the cry, to paraphrase Senator Russell Long:

"Don't simplify you, don't simplify me,
Simplify the fellow behind the tree."

2. Tax Equity. Tax expenditure analysis has changed the analysis of tax equity issues in fundamental ways. Given the construct of tax expenditure transactions described above, the tax equity issue is not whether there are "loopholes" in "tax preferences". Instead, the tax equity issue is whether the tax expenditure itself is treated correctly for income tax purposes.

Let me illustrate this point by reference to the business tax credits. Some business tax credits are included in the income of the taxpayer, either directly (the alcohol fuel tax credit) or indirectly (e.g., the targeted jobs tax credit through a reduction in the deduction for wages). In these situations, there is no tax equity issue present at all. These subsidies are included in income just as a direct subsidy would be.

As another example, some elements of the investment tax credit require a full reduction in the basis of the assets to which the credit relates (e.g., the rehabilitation tax credit). In effect, the amount of the credit is included in the income of the taxpayer over the depreciable life of the asset. There is respectable authority that this is the correct tax treatment of the subsidy, just as it is in the case of a direct subsidy which represents a contribution to the capital of a corporation (see sections 118-362(c)).

Many business subsidies are in the form of deferrals of tax. As is by now well known, these tax deferrals are the equivalent of interest-free loans. The tax equity issue, under tax expenditure analysis, is not the granting of the loan. The tax equity issue is the failure to apply our below-market loan rules to these tax loan subsidies.

Thus, under tax expenditure analysis, the scope of tax equity concerns is considerably different from traditional "base broadening" analysis. This does not mean that there are not equity issues in the tax expenditures. But, these are spending equity issues, not tax equity issues. For example, is it really fair for a high-bracket farmer to receive a larger tax loan via the cash method than is his low-bracket neighbor? Such questions, of course, drive us to consider the appropriate design of the tax expenditure program. It may be, for example, that we can design an equitable farm subsidy more readily if it is a direct subsidy program. But tax expenditure analysis requires that we recognize that we are dealing with program design issues, not tax equity issues.

I fully recognize that the average taxpayer does not walk around with tax expenditure analysis buzzing in his or her head. But I think they understand its point better than is generally recognized. Public opinion polls, for example, have reflected two views: One, everyone should pay their fair share of the income tax; two, do not repeal the deduction for home mortgage interest. Some have interpreted these data to conclude that average citizens hold conflicting views. I believe another interpretation is possible. The average citizen does want a fair tax system; that citizen also wants to retain a needed subsidy and it does not matter whether that subsidy is run through the tax system or is run directly. And, of course, the citizen is correct. If the home mortgage interest tax subsidy were itself treated correctly for tax purposes (i.e., included in income), there is no inconsistency at all between tax equity and granting a tax subsidy. Those of us concerned with tax policy need to keep in mind this common sense approach of the average taxpayer as we consider tax expenditure provisions.

CONCLUSION

In this statement, I have attempted to present quite different approaches to analyze the FAST and FAIR tax proposals. Which approach is taken can affect the ultimate fate of either bill. My own view is that the most feasible strategy to achieve the traditional goals of tax simplification and tax equity is to adopt the less traditional technique of tax expenditure analysis. The latter technique involves an arduous political process and a rigorous and time-consuming evaluation of each tax expenditure offered by the proposals. But, in the end, I believe it is the only approach which offers the possibility of satisfying the objectives of tax reformers and beneficiaries of tax expenditure programs alike.

Chairman ROSTENKOWSKI. Dr. Bradford, you may proceed.

STATEMENT OF DAVID BRADFORD, PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, PRINCETON UNIVERSITY, AND DIRECTOR OF THE RESEARCH PROGRAM IN TAXATION, NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. BRADFORD. Thank you very much, Mr. Chairman.

I, too, appreciate the opportunity to be here today and participate in the discussion of fundamental reform.

In reporting on recent hearings before the Finance Committee, Tax Notes observed that a pattern had developed in the testimony offered by various witnesses.

There is a representative of the common man who advocates a modified flat rate tax plan. Special interests advocate their special interests. Representatives of large accounting firms do not advocate much of anything. And at least one tough guy advocates a pure flat tax or a pure consumption tax.

I am apparently the tough guy on this panel in that I do advocate shifting our tax system to a consistent consumption type or consumed income base. And in discussing the subject today, I am responding to the chairman's letter in which he asked me to do so.

I also would like to take a chance to put in a small plug for the place I learned about the subject, which was at the U.S. Treasury Department in 1975 and 1976 when I served as Deputy Assistant Secretary. The most interesting thing I did was to help in a study which was published by the Treasury Department called "Blueprints for Basic Tax Reform," which presented both a comprehensive income type and a comprehensive consumption type tax plan.

The plug is for the reissue of that study by Tax Analysts, who publish Tax Notes, and I should say that is a charitable activity, neither they nor I stand to profit from sales of the book. But we think it is a very useful one, and now available again.

I prepared for the record a rather lengthy document in which I basically address the issue of the simplification advantage of going toward a consumption type tax. I will definitely not try to summarize or compress that rather lengthy discussion here.

I think it may be more helpful if I make some more general points about the pluses and minuses of making a transition to a consumption type tax. First, as to definitions.

I should say what the tax theorists mean by income is not what the layman means, and it is not what is defined in the income tax law, or in either of the tax reform programs that were just discussed. The theoretical concept could perhaps best be described by the words "accrual income".

We usually describe it by saying income is the sum of consumption and savings during the year. The accrual part concerns the savings, which are defined as the change in a taxpayer's wealth over the year. And that is where the trouble comes in, because wealth is very difficult to measure, and measuring a change in wealth is doubly difficult, because we don't have any observation on what most things are worth at the beginning and end of the year.

As a consequence, we have to provide in our tax law rather complicated rules involving such devices as depreciation, amortization, and depletion allowances and such approximations to the measurement of income as are involved in taxing capital gains upon realization rather than as the value changes actually occur, whether gains or losses, as the taxpayer holds assets.

None of these rules are very simple, nor do they do their job very well in measuring the thing that the theorists call income. It is partly for this reason that the system we now call an income tax is really not an income tax at all.

I think it is also in part because the layman, as I said, really doesn't think about income in the technical sense I just described it. The layman who holds a share of stock during the year and sees it increase in value doesn't want to have that increase labeled income unless the stock is sold, even though there has been a wealth change.

In any event, the system right now is ridden with inconsistencies in the treatment of savings transactions. And the accounting system that we use for tax purposes is in serious disarray. And that is why I say what we now have is not an income tax.

There are things we could do. We could try to really make an income tax out of it. No one is seriously proposing that.

A more attractive possibility in my view is to eliminate the savings element from the tax base. If we do that, what we are left with is consumption. And that is the difference between an idealized income and consumption tax; it is entirely in the treatment of savings.

As I say in the written testimony, I have stressed the simplification advantage of changing the point of view about what it is we are trying to tax. By changing it away from income in its accrual sense to the idea of consumption, we can shift to types of accounting rules that are just basically very, very much simpler than those we need to deal with an income account.

In fact, I think it is fair to say that the resulting rules, which are reasonably captured by the notion of cash flow accounting, come closer to what the layman thinks about as the right notion of income.

Now, it would not be sufficient to say this is a simpler tax system. There are many simple tax systems. We could just send everyone a bill for an appropriate share of aggregate Federal expenditures; that would be simpler than anything else.

But it would not be a very good tax system. It is not enough to say that the consumption approach offers a simple tax system, but in my view, it also offers substantial advantages both in its basic fairness and in the efficiency with which resources are used.

Let me turn quickly to these two further topics, the question of the fairness of the consumption base and the question of efficiency or neutrality.

The case in fairness is really simply this. We know individuals and families differ in many ways. They have different wages, different numbers of workers in the family, numbers of children, varying degrees of health, different age and so on. In determining how to share the tax burden fairly we pay attention to some of these differences and neglect others that we don't regard as important for defining differences in tax burden.

Thus, we regard it as reasonable that a person who has a high salary should pay more in tax than a person working at the minimum wage. We think it is reasonable that a person with large health medical expenditures should pay less in taxes than a healthy person with no such expenditures and so on.

The critical difference between an income tax and a consumption type tax is that the income tax imposes a heavier tax burden on the saver than on the one who saves less. So it makes a discrimination not only on the basis of how high the salary is, or the health of taxpayer—but also on how much the taxpayer saves.

We are talking here about differences that might occur from individual to individual or family to family at each level of economic welfare. People differ in their savings behavior, either because they make choices to save more or less, or just happen to by habit or other circumstance—they differ in the way they save. I don't understand why we should want to use as a basis for varying the amount of tax burden we put on people whether they decide to save more or less.

I could see an argument, in fact, that maybe we should encourage saving as a good thing. We should reward it. But I certainly don't understand why we would want to have a system that would encourage current consumption and discourage saving as a matter of tax equity. If the position is taken that we really want to let people make their own choices on that matter and not have that affect their tax burden, then the consumption type approach is what we want. It has not only the great advantage of being a simpler approach, but it has a distinct advantage in my view of fairness.

A brief word about the efficiency of the consumption approach:

The major advantage of the consumption approach in my opinion is that it permits a very highly consistent method of levying taxes on savings and investment. In fact, there is no change in tax burden as a result of deciding to save or invest more.

The problem with an income tax is not so much that it puts a positive tax on saving or investing, although it does, but because it puts variable burdens on that kind of activity. The consequence is we have some types of investments and saving activity very heavily taxed—a person who holds interest-bearing bonds in a time of inflation is heavily taxed—and others—for example, assets on which we would allow very rapid accelerated depreciation—are very lightly taxed.

The consequence of that is a fairly serious distortion in the way we use our savings. Not so much how much we have, but how we use it.

Practical income taxes simply result in very serious distortions in the uses we make of our savings.

Let me then conclude with a few remarks about why the consumption tax advocate is regarded as the heavy. Why am I considered a tough guy for advocating such sensible views?

I think there are really two reasons. One is that many people believe that a shift to a consumption type tax would be regressive. The second is that they think the transition would be unfair. And there are cursory two contributory concerns here.

One is that it would be unfair to tax the consumption of people who have accumulated their savings under the present tax system—it would be unfair to tax them again if they consume it in their retirement years. So it is unfair to double tax past savings.

The other argument is exactly the opposite, and that is if we don't tax past savings, we are giving an unfair windfall to those who have accumulated in the past.

There really isn't any way to fully square that circle, I think, although my own view is that those matters of adjustment to the existing situation are ones that we could handle if we just made up our minds where we wanted to get to was a consumption-type tax.

In my view, the more people think about it, the more people will think that is where we don't want to get, and once we have drawn that conclusion there is a question between political leadership, political compromise of a sort we have been through many times in programs of at least similar magnitude as far as their distributional effects are concerned, and we will find a way to make the appropriate compromise in averages—transitions, grandfathering and so forth.

As far as transition is concerned, it is argued we are rather close to the consumption tax base right now. Certainly it is widely believed that high bracket taxpayers pay little, if any, taxes on their savings.

And a simple rough test would be simply to ask ourselves whether your income tax burden would be higher or lower if we did the following things—eliminated the taxation of dividend and capital gains and we eliminated both the taxation and deduction of interest.

I think for many people the result of that change, which would be the basic step you would need to convert the present system to consumption base would be an increase in taxes, not a decrease. I think for high bracket people in particular the result would be an increase in taxes not a decrease.

So we are rather close to it now. And it should be a matter that we could deal with if we decided we wanted to make a shift to a consistent consumption base.

Finally, I think the consumption tax advocate is regarded as a tough guy just because we are in the habit of thinking of income as the right measure of ability to pay. And I really do think this is just a matter of habit.

It is a doctrine we have lived with for 50 years. In the recent years we have been rethinking it. I think we will quite possibly change our views with time.

If we simply keep in mind the differences between accrual income tax and a consumed income tax is that the former discriminates among taxpayers on the basis of the amount of saving, with the heavier burden on the savers and a lighter burden on the dissavers and borrowers, at every level of economic welfare, where all tax burdens under the consumed income tax are independent of that characteristic of people, whether they save more or less—then I think it is difficult to see why we would want to stick with income as the desired target of our tax base, and rather we should make the shift all the way to a consumption target, with all of its many advantages.

Mr. PICKLE [presiding]. Thank you, Professor.

[The prepared statement follows:]

STATEMENT OF DAVID F. BRADFORD, PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, PRINCETON UNIVERSITY, AND DIRECTOR OF THE RESEARCH PROGRAM IN TAXATION, NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. Chairman and members of this distinguished Committee, I am most grateful for the invitation to present my views today on the possible advantages of shifting our tax system toward one based on consumed income.

The interest shown recently in proposals for a far-reaching reform reflects continuing dissatisfaction with the U.S. income tax. Three major complaints may be distinguished:

(1) The tax law is too complicated. The ordinary taxpayer cannot understand it.
(2) High tax rates induce people to evade the law or at least to waste resources on reducing taxes instead of producing something useful.
(3) Because well-to-do taxpayers can afford to take advantage of loopholes, they don't pay their fair share.

None of the complaints listed is new. What we have to ask ourselves is whether a new opportunity exists to deal with the problems in a way that will stick. Or are we rather witnessing just another visitation of the "broaden the base, lower the rates" sentiment that, like the Asian flu, breaks out in the U.S. from time to time.

What may be new in the present is an increased awareness of the distorting effects of very high tax rates (as seen in the emphasis on lowering the rates relative to the emphasis on broadening the base). What is still missing, by and large, is a clear-sighted concept of the desired tax base--that is, the definition of income subject to tax.

The earlier base-broadening efforts lacked such a clear objective, and consequently they added patches to an existing crazy quilt. In that setting each patch is the potential subject of a political struggle, and if there is no clear reason why one side of the struggle should prevail in the general interest, there is no hope for imposing rationality on the law as a whole.

It would, of course, be naive to assert that having a well thought through goal of income tax policy is an absolute guarantee against erosion of a tax base by deductions and credits inconsistent with that goal. I do believe, though, that without a clear strategy we cannot hope to avoid mounting complexity, with attendant distortions and taxpayer dissatisfaction.

In contemplating changes it is important to recognize that a tax law does not consist simply of a statute enacted by the Congress. It includes as well the great web of regulations, rulings and the like that translate the statute into practice. Regardless of how short or simple its wording, a statute lacking a consistent rationale cannot be simple and equitable in practice. What could illustrate this better than a statute establishing a tax on "income from whatever source" but failing to provide an economically consistent definition of income to guide implementation?

"Economic consistency" prevails when the tax consequences of two economically equivalent events are the same. Present law has reached a point of extreme confusion, particularly about the treatment of savings and investment. Let me give an example or two of the lack of economic consistency in our present tax law:

Consider a taxpayer in the fifty percent marginal rate bracket with $1,000 to invest for his retirement in 25 years. If he puts his money into a money market fund yielding, let us say, 15 percent, and withdraws enough each year to pay the income tax due on his interest, at the end of twenty-five years his $1,000 will have grown to $6,521. Suppose instead he can find an asset with the same rate of return but for which the yield comes in the form of capital gain. The situation is economically equivalent to the one first described. But he will pay no tax at all until the end of twenty-five years, at which point the gain is realized to finance retirement consumption. After paying tax at long-term capital gains rates, in the second case he will have $34,217 instead of $6,521. Even without the favorable tax treatment of long-term relative to short-term gains the advantage of deferral would mean the second approach would yield him $21,761 instead of $6,521.

Suppose, to carry the example a step further, our taxpayer elected to borrow $1,000 (at 15 percent) to add to his own $1,000, so he could purchase more of the capital gain asset. Now he would have interest deductions each year. To make the comparison easier, suppose he borrows enough extra each year to pay the interest net of his annual tax savings, with all the debt to be repaid at the twenty-five year point. Once again, in the absence of taxes, his real situation would be the same as in the previous examples: he sets aside $1,000 of his own money in the first year, reaping any return twenty-five years later. But now, the combination of the favorable treatment of long-term capital gains, the deferral of tax on accruing gains, and the deduction of interest provides him with $61,913 instead of $6,521. (This example is particularly interesting as it shows how the tax system may even improve the yield on the wealth of the higher bracket taxpayer. Here his proceeds after twenty-five years exceed the $42,521 he would have obtained in the absence of any tax on interest or capital gains.) Finally note that even without the favorable long-term capital gains rate, our investor would have $37,001 after twenty-five years under the scheme with borrowing.

These illustrations of inconsistencies in existing income tax law could easily be multiplied. Inconsistencies may be of many kinds. For example, there are many distinctions made between employee compensation received in the form of cash and that received in the form of various fringe benefits which make little economic sense. But the most mischievous cases have to do with transactions over time. These are essentially differences in the tax treatment of the economic equivalents of borrowing and lending. To exploit them the taxpayer does not have to change his occupation or life style, just his portfolio.

It seems obvious that reduced tax rates will mean inconsistencies are also reduced in significance. However, unless the rates are drastically lowered, the importance of careful structuring of the rules will not be diminished. To illustrate, suppose the tax rate in the examples above were 25 percent instead of 50 percent, and there were no preferential rate applicable to long-term capital gain, although capital gains continued to be taxed on a realization rather than accrual basis. Then our ordinary saver would reap $16,651 from his $1,000; the taxpayer putting his money in the capital gain asset with $1,000 of borrowed funds, $47,631. Cutting the rate in half has lowered the relative advantage of the third strategy but actually increased the dollar advantage (except compared to the situation in which long-term gains are taxed at 40 percent of the regular rate).

The dramatic quality of these particular examples depends upon the high rate of interest I have assumed. Clearly a rate of interest of 15 percent is extremely by historical standards. Recent yields at that level are a phenomenon of the inflationary times. However, the general lessons remain valid even at lower rates of interest:

(1) Taxpayers may have enormous incentives to seek out and exploit inconsistencies in the tax treatment of saving and investment.
(2) While lower rates of tax will tend to reduce many distortions, they will not eliminate them, and they may leave surprisingly large distortionary incentives.
(3) It takes careful thought to design a tax system having a high degree of consistency, especially one that can be administered by ordinary human beings.

In the realm of possible individualized taxes, that is, taxes whose rates can be varied to reflect individual circumstances, there are basically two serious contenders. One is grounded in the notion of income as the sum of consumption and saving during the year, taken as a measure of taxpayer well-being. The second, in the category of consumption taxes, is grounded in the taxpayer's longer-term consumption power. Either of these can in principle be adopted as the "clear objective" of which I have spoken.

It was my good fortune during 1976 to direct a staff study in the Treasury Department to see what really could be done to broaden the base and lower the rates through very careful application of these alternative principles. The report of that study was published by the Treasury Department in January 1977, under the title, Blueprints for Basic Tax Reform. In my no doubt biased view, that report should be required reading for tax policy makers. (The study has just been reissued, with minor revisions, by Tax Analysts, publishers of Tax Notes.)

Blueprints presents two illustrative tax plans, designed to replace our present income tax on both individuals and corporations. The first plan is called the Comprehensive Income Tax, and implements the theoretical idea of income as the sum of all consumption and saving during the year. The second plan is called the Cash Flow Tax and implements the theoretical idea of taxing on the basis of the individual's long-term level of consumption.

In concept the Cash Flow Tax differs from the Comprehensive Income Tax in exempting the returns to saving. It says to the taxpayer, if you decide to put money aside to consume in the future we won't increase your tax burden. It turns out that this difference in concept allows an enormous difference in simplicity of implementation.

There are two ways to implement the exemption of savings. The first uses the approach now taken with respect to qualified retirement savings: amounts set aside are deducted from the tax base, and subsequent pay-out is included in the base. The second simply ignores both the input and the output sides of saving. No deduction is made for the amount saved, and the subsequent return is not taxed. If we think of the tax as assessed on consumption, the second approach amounts to prepayment of tax. Implementation of what I call the long-term consumption level approach to taxation can take advantage of these two techniques. Either one allows the use of very simple rules, which essentially involve only keeping track of cash flows. (This is the origin of the name of the system in Blueprints called the Cash Flow Tax.)

The bulk of the Blueprints report is devoted to explaining the tax concepts, including details on a great variety of specific issues (e.g., how to tax earnings on life insurance: how to implement integration of corporation and shareholder accounts; what personal deductions make sense; how should second earners be taxed). One chapter is devoted to quantitative estimates of the distribution of existing income tax burdens. In that context, the report develops structures of exemptions and rates applicable to the broadened and rationalized bases, and designed to approximate the then existing pattern of tax burdens.

The quantitative estimates in Blueprints are, of course, just that, estimates. Many questions can be rightfully raised about the adequacy of the methods by which they are constructed. However they do provide one careful approach to the problem of estimating the distribution of tax burdens.

Table 1 presents figures, derived from the Blueprints data, on effective tax rates. By "effective tax rate" in this case is meant the ratio of each household's actual burden to that household's broad-base income. There are thus two sets of rates corresponding to the different denominators of the effective tax rate calculation, and these rates are in turn developed to represent the burdens under two different tax laws. The columns labeled "1976 law" are taken from Blueprints, and reflect the burdens of the individual and corporation tax rules then in effect. (The classifiers have been inflated to express the income categories in 1984 dollars).

The columns labeled "1984 law" express my guess about what has happened to the law since 1976. The 1984 law columns are obtained from the 1976 law figures by allowing for the drop in rates, bracket creep and the effect of inflation on personal exemptions. (Overall the individual income tax law of 1984 will raise more revenue in real terms than would the law of 1976 adjusted for inflation--a commentary on the "tax cuts" of recent years.)

Even if only rough approximations, the figures are informative. They tell us, for example, that the income tax system as a whole, for all of its inconsistencies and loopholes, is quite progressive. The burdens it imposes increase with income and the increase is more than proportional. That is, the ratio of tax burden to either measure of taxpayer well-being rises with the level of the measure.

We can also use the data to evaluate the effects of implementing a flat tax on a broadened base. The Blueprints estimates imply that a single proportional rate applied to one of the broad bases, or any closely related broad base, will certainly involve big changes in the distribution of tax burdens. A rate of 14.35% applied to the Comprehensive Income Base (or 15.73% applied to the Cash Flow Base) would have been sufficient to raise the revenue generated by the income taxes on individuals and corporations in effect in 1976. Blueprints figures imply that such a flat rate would lead to large reductions in taxes for the well-to-do and large increases for the less well-off.

Some, perhaps most, flat-rate tax plans now under discussion provide for progressivity through the use of exempt amounts of income. We cannot read off from Table 1 the structure of exemptions that would allow a reasonable approximation to the existing tax burdens. If it is desired to maintain a degree of progressivity like that at present, the flat marginal rate must be reasonably close to the average rate on the highest income class. One might, for example, approximate the Cash Flow effective rate results for 1984 law by a flat-rate tax of roughly 30 percent, with exemptions of something like $3,600 per tax return plus $3,600 per taxpayer plus $1,800 per dependent (in 1984 dollars). This would probably mean a tax cut for those with very little cash flow income, an increase for those in the middle, and some decrease for the highest cash flow income recipients.

The implied effective tax rates for taxpayers in various filing circumstances at various Cash Flow base levels are shown in Table 2. A

Table 1

Effective Rates of Combined Individual and Corporation Income Tax

Comprehensive Income Base Class	Effective Tax Rate 1976 Law	Effective Tax Rate 1984 Law	Cash Flow Base Class	Effective Tax Rate 1976 Law	Effective Tax Rate 1984 Law
($000 (1984))	(percent)		($000 (1984))	(percent)	
Less than 0	-0.6	-0.6	Less than 0	0.0	0.0
0 - 9	1.7	3.4	0 - 9	2.2	4.4
9 - 18	6.4	10.6	9 - 18	7.4	12.2
18 - 27	9.9	12.9	18 - 27	11.8	15.3
27 - 35	12.7	14.0	27 - 35	14.8	16.3
35 - 53	15.4	15.4	35 - 53	18.0	18.0
53 - 88	19.8	19.8	53 - 88	23.6	23.6
88 - 177	25.2	22.7	88 - 177	30.7	27.6
177 or more	32.4	25.9	177 or more	36.0	28.8

Table 2

Effective Tax Rates Under Illustrative Flat-Rate Tax*

Cash Flow Base	Filing Status				
	Single	Joint (number of dependents)			
		0	1	2	3
($000)	(present)				
5	0.0	0.0	0.0	0.0	0.0
10	8.4	0.0	0.0	0.0	0.0
15	15.6	8.4	4.8	1.2	0.0
20	19.2	13.8	11.1	8.4	5.7
45	25.2	22.8	21.6	20.4	19.2
70	26.9	25.4	24.6	23.8	23.1
100	27.8	26.8	26.2	25.7	25.1
1,000	29.8	29.7	29.6	29.6	29.5

*Tax is 30 percent of excess over $3,600 plus $3,600 for each taxpayer plus $1,800 for each dependent, not including spouse.

rough sense of how well this flat-rate tax approximates the existing one may be obtained by comparing the figures in Table 2 with those in the last column of Table 1.

I draw two lessons from exercises with the Blueprints data. First, a flat-rate tax system could be constructed to replace the existing corporation and individual taxes that is not greatly different in overall progressivity from the existing system. My illustrative calculations are far from conclusive, but I would guess that for a reasonable approximation to the present progressivity that flat rate would have to be somewhat higher than the levels I have seen discussed. A flat-rate tax will almost certainly involve an increase in burden on the middle income households and a reduction in burden on the lowest and perhaps highest income households. The marginal rate that will be read off the tax return will be much higher for many households than it is at present. The highest marginal rates, ranging up to 50 percent, will, of course, be eliminated.

Second, any shift to a flat tax will involve great redistributions of tax burdens. Many taxpayers will bear markedly higher or lower taxes after than before a change to a flat rate scheme. We should keep in mind, of course, that the data used in the Blueprints study were in part a response to the structure then existing. Many households have mortgage interest deductions, for example, because the tax system makes home-owning attractive. A finding that homeowners' taxes will be raised relative to renters' would then have to be tempered by the fact that a change in the tax system reducing the incentive to own homes would reduce the number of homeowners as well. The response of taxpayers to changes in the rules will tend to reduce the distributional significance of the change.

Still a shift to a flat-rate tax will clearly effect large redistributions, and we may well ask whether those redistributions could be reduced by applying a graduated rate structure instead of a flat rate to the expanded base. The Blueprints study concluded this to be the case. Table 3 translates into 1984 dollars the structure of rates that the Blueprints report suggested to approximate the tax burden distributions existing at that time. Were we to use the 1984 standard, the top rate would be lower and the structure of exemptions and other rates would be rearranged to take more in tax from lower and middle income households.

It is a general principle that allowing greater freedom in the design (for example, three rates instead of one) will permit a closer approximation to any given tax objective. In this case the objective was to match tax burdens under existing law. Nevertheless, analysis of redistributions contained in the Blueprints report suggests that even with a relatively flexible structure, and making allowances for the limitations of the analysis, considerable changes in tax burdens would be effected in a move from current law to either reform plan. The question is, is the game worth the candle?

In replying with a qualified yes, I would like to return to my opening theme of the need for a clear-cut strategy of taxation. The advantages of broadening the base will be few if it is not at the same

Table 3

Blueprints Rate Structures*

Comprehensive Income Tax		Cash Flow Tax	
Basic exemption: $3,010 per return plus $1,881 for each taxpayer and dependent		Basic exemption: $2,822 per return plus $1,505 for each taxpayer and dependent	
Comprehensive Income bracket (dollars)	Marginal tax rate (percent)	Cash Flow bracket (dollars)	Marginal tax rate (percent)
Joint returns:		Joint returns:	
0 - 8,654	8	0 - 9,784	10
8,654 - 75,258	25	9,784 - 56,443	28
over 75,258	38	over 56,443	40
Single returns:		Single returns:	
0 - 5,268	8	0 - 6,020	10
5,268 - 75,258	22.5	6,020 - 56,443	26
over 75,258	38	over 56,443	40

*Adjusted for inflation from 1976 to 1984. These rates, together with special rules for secondary workers, were designed to yield approximately the same distribution of tax burdens as was generated by 1976 law.

time a move towards simplicity and consistency in the law. And to this end, my view has increasingly become, the clearly dominating approach is that of the consumed income base.

I would be glad to discuss today the reasons a strategy of taxing on the basis of long-term consumption level is preferable to a strategy based on the classic notion of annual income. It seems to me the consumption approach has the advantage on all the three usual criteria: equity, efficiency, and simplicity. But the aspect I would like to stress today is the potential contribution of the consumption approach to simplifying the law.

For illustrative purposes I shall use the Blueprints Cash Flow Tax as representative of consumed-income taxes more generally. I would stress, however, that the basic advantages of cash flow accounting apply equally to several alternative plans--including, for example, the Hall-Rabushka Simple Flat Tax. In brief outline, a taxpayer's Cash Flow is the sum of cash compensation, pension benefits and other transfers, gifts and inheritances received, gross receipts from unincorporated businesses, and withdrawals from "qualified accounts" (like present IRA's) less contributions to qualified accounts (including qualified retirement accounts), all business outlays (including capital outlays), and gifts or bequests to another taxpayer. (Deductions for such items as charitable contributions and state and local income taxes could be allowed or not as a matter of policy.) Such items as interest and dividends received and proceeds from the sale of assets are not included, nor are deductions allowed for interest paid, depreciation or the cost of assets sold. The resulting total can be taxed either at graduated rates as now, or at a flat rate above an exemption.

Table 4 goes into more detail on the items included and deducted under versions of the Cash Flow Tax and the Comprehensive Income Tax. I have carried these labels over from Blueprints, even though the rules described in Table 4 differ in minor ways from Blueprints. The Comprehensive Income Tax is included in the table for its own interest and for the purposes of illustrating the simplicity advantage of the Cash Flow Tax.

In setting out the systems described in Table 4 I have tried to be as rigorous as possible in adhering to the underlying ideas of, on the one hand, taxing consumption plus accumulation of wealth during the year (the Comprehensive Income Tax) and, on the other, taxing the households' long-run consuming power (the Cash Flow Tax). It will be readily seen from the number of double "yeses," there is a great deal in common between the two tax systems. The instances in which important transactions are treated differently have been highlighted by asterisks in the table.

What is striking to anyone who knows how tax laws are actually administered is how many problem areas in Table 4 are confined to the Comprehensive Income Tax alone. Let me single out the three most important instances for brief elaboration: interest received or paid on financial assets (receipts items R-4, deduction item D-4), integration of

TABLE 4

From David F. Bradford, "The Choice Between Income and Consumption Taxes," Tax Notes, August 23, 1982, pp. 715-723.

Information on Tax Returns for Illustrative Comprehensive Income and Cash Flow Taxes

(Items preceded by a bullet are treated differently under the Comprehensive Income Tax and the Cash Flow Tax.)

	Household Receipts and Deductions	An Element of	
		C.I.T.	C.F.T.
Receipts:			
R-1	Wages, salaries, tips, royalties, etc., subject to tax.[1]	Yes	Yes
R-2	Receipts of pensions, annuities, disability compensation, workmen's compensation, and sick pay.[2]	Yes	Yes
• R-3	Gifts, inheritances, trust distributions and life insurance death benefits received.[3]	No	Yes
• R-4	Interest received on financial assets, *adjusted for inflation.*	Yes	No[4]
R-5	Dividends received on corporate earnings.	No[5]	No[4,6]
• R-6	Allocated share of *inflation corrected* corporate earnings.	Yes	No
• R-7	Policyholder claim on earnings from life insurance, annuity, and pension plan reserves, *adjusted for inflation.*	Yes	No
• R-8	Increase in value of the claim on a trust, beyond allocated share of amounts given or bequeathed to the trust, *adjusted for inflation.*	Yes	No
• R-9	Proceeds from the sale, exchange or distribution of capital assets.	Yes	No[4,6]
• R-10	Imputed service value attributable to owner-occupied housing and other household durables.	Yes	No
R-11	Gross receipts from unincorporated business enterprises.	Yes	Yes
• R-12	Withdrawals from qualified accounts (including withdrawals of borrowed funds).[7]	No	Yes
R-13	Total receipts (sum of included items R-1 — R-12).		
Deductions:			
D-1	Special items as a matter of policy (e.g., charitable contributions, medical expenses).	Yes	Yes
D-2	Contributions to qualified retirement plans.	Yes	Yes
• D-3	Gifts and bequests made to an identified taxpayer or trust with eligible beneficiary (cf. receipts item R-3).	No	Yes
• D-4	Interest paid on indebtedness (including interest on home mortgages), *adjusted for inflation.*	Yes	No[4]
• D-5	Net life insurance premiums.	No	Yes
D-6	Employee business expense (includes qualified travel expenses, union and professional association dues, tools, materials and qualified educational expenses).	Yes	Yes
• D-7	Basis of assets sold, exchanged or distributed (cf. receipts item R-9), *adjusted for inflation.*	Yes[9]	No
D-8	Current expenses associated with unincorporated business enterprises.	Yes	Yes
Deductions (Continued)			
• D-9	Capital outlay associated with unincorporated business enterprises.	No	Yes
• D-10	Depreciation allowances for current and past capital outlays associated with unincorporated business enterprises, *adjusted for inflation.*	Yes	No
• D-11	Deposits to qualified accounts (including repayment of borrowed funds).	No	Yes
D-12	Total deductions (sum of included items D-1 — D-11).		
Tax Base:			
B-1	Total receipts less total deductions (R-13 minus D-12).		

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[1] The definition of "wages subject to tax" could incorporate differential rules according to individual characteristics (for example, marital status might be used to mitigate the "marriage tax" problem). This item would *exclude* social security taxes attributable to retirement benefits and contributions to retirement plans. It would *include* employer-paid health and life insurance premiums, and similar employee benefit outlays.

[2] This item would probably include social security benefits of all types. Pensions and annuities for which there has been no excusion under R-1 or deduction under D-2 or D-11 would be excluded under R-2.

[3] The exclusion of gifts and inheritances received under the illustrative Comprehensive Income Tax may be rationalized by the difficulty in measuring accruing wealth from anticipated inheritance. Correspondingly, the giver, bequeather, or life insurer receives no deduction from the Comprehensive Income Tax Base (deduction items D-3 and D-5). The same system could be applied to the Cash Flow Tax. Alternatively, with appropriate modification of the treatment of life insurance and trusts, the Comphrehensive Income Tax could follow the illustrative Cash Flow Tax usage, and vice versa.

[4] Under the illustrative Cash Flow Tax a significant distinction is made between assets owned on a "tax prepaid" basis, the return on which is excluded from the base, and assets owned via qualified accounts, the return on which is ultimately included in the base when withdrawn. See footnote 7 below.

[5] The exclusion of dividends under the Comprehensive Income Tax is a corollary of the allocation of all corporate income to shareholders. Dividends result in a reduction in the "basis" of the shares for purposes of calculating gain from sale or exchange (capital gain).

[6] Under the Cash Flow Tax qualified account treatment would be obligatory for closely held corporations. See footnote 7 below.

[7] "Qualified accounts," which are similar to IRA's and H.R. 10 Accounts in current U.S. income tax law, play a critical role in the CashFlowTax. All inflows are deducted from the tax base, and all outflows are included. Nothing transpiring inside the account has direct tax consequences.

[8] Borrowing via qualified account (cf. fn. 7) is included in the tax base and *all* consequent return payments into the account, whether of principal or interest, are deducted. However, neither interest on nor repayment of borrowing outside of a qualified account has tax consequences under the Cash Flow Tax.

[9] The deduction of adjusted basis would have to be limited, as at present, in relation to sales proceeds in R-9. Unused deduction of net losses could be carried forward.

55 /[illegible]

corporation and shareholder income accounts (R-6), and capital gains (R-8 and D-8). I shall take them up in reverse order.

Inclusion item R-8 and deduction item D-8 together accomplish the taxation of capital gains in the Comprehensive Income Tax. Ideally, a taxpayer who enjoys an increase in the value of an asset he owns during the year should be taxed on that increase under an income tax. And conversely, if an asset declines in value, a corresponding reduction should be made in the taxpayers' income accounts. However, it is generally felt that estimating the accrual of such gains and losses is beyond the reach of practical accounting. Consequently, the procedure of recognizing capital gains and losses only on realization through sale or exchange has been accepted in our actual tax law and in the Blueprints Comprehensive Income Tax.

It turns out that the realization basis for accounting has endless mischievous consequences in any economy in which the economic reality of concern to taxpayers is the accrual of gains and losses. We have seen above the large rewards from deferral accorded to capital gains assets as a result of realization accounting. Furthermore, the opposite sort of advantage obtains in the case of capital losses. A policy of realizing losses and postponing gains is standard operating procedure for investors under existing law. It is difficult to exaggerate the complexity a realization approach to income accounting introduces to the law as it affects the conduct of business affairs of any significance.

Next notice that innocuous phrase, "adjusted for inflation." In a remarkable study a few years ago, Martin Feldstein and Joel Slemrod analyzed the capital gains on corporate stock reported by taxpayers on their returns for 1975. Feldstein and Slemrod found that while in the aggregate there was reported a gain of $6 billion, if the basis of the shares had been corrected for the change in the price level between the time of acquisition and the sale of the shares, the amounts would have actually aggregated to a loss of $1 billion. If the tax system is to be based on real rather than purely nominal quantities, adjustment of capital gains basis for inflation is an essential, even if unpleasant complication.

Finally, on the subject of capital gains, I would note the challenge it poses to fair and effective administration. Keeping track of sales, exchanges, and the basis of assets presents great administrative problems, both to the tax authorities and to taxpayers.

The illustrative Cash Flow Tax allows a taxpayer alternative ways to account for assets purchased or sold. On the one hand, there is the option to obtain assets through qualified accounts (see footnote 7 to Table 4). Outlays to purchase assets in this form are deducted from the tax base and proceeds of the sale of assets withdrawn for consumption are added to the tax base via the recorded addition or withdrawals from qualified accounts (as under present-day Individual Retirement Accounts). Under the alternative procedure, no deduction is allowed for the acquisition of an asset and none of the returning cash flow is subject to tax. The sale of an asset for which no deduction has been taken would have no tax consequences at all. No inflation adjustment would be necessary under either of these approaches.

Let me turn now to a discussion of the taxation of corporate earnings. Under a full-fledged accrual tax system, the change in value of an equity owner's shares in a corporation during the course of the year would be treated as income subject to tax. As we lack such an accounting system, if distortions (of the sort discussed earlier in connection with capital gains) are to be avoided, it is essential to have some method of attributing corporate earnings to shareholders. This is the well-known problem of integrating the accounts of corporations and their shareholders. Receipts item R-6 notes the necessity of including such an allocation in the Comprehensive Income Tax.

Again, the unpleasant problem of adjusting for inflation is present. Inflation wreaks havoc on corporate tax accounts-- the chaotic state of accelerated depreciation allowances and investment credits, the mixture of LIFO and FIFO inventory accounting systems, and many other features of current economic life are attributable in large measure to inflation. There simply is no well-understood, well-accepted method of accounting for corporate earnings in a time of inflation, and yet it is essential that taxes be based on real and not purely nominal profits.

Then there is the problem of allocating those profits to the shareholders. Blueprints, indeed, presents an innovative method for accomplishing this task of integration. However, it would not be widely regarded as terribly simple and it certainly reflects a difficult change from current practice.

Under the Cash Flow tax, it is unnecessary to allocate the earnings of corporations to shareholders.

Under an income tax it is normal to measure gain on amounts loaned by the taxpayer by treating the interest received as income, and to measure the sacrifice of consumption or wealth incurred by a borrower by allowing a deduction for interest paid. In a time of inflation, however, this measurement method may be widely inaccurate. This is a matter which is still all too little understood and yet extraordinarily important.

Inflation produces an "inflation premium" in interest rates. Unfortunately, it is not easy to determine what that premium is, since it depends upon hard-to-observe anticipations of future price level changes. But failure to adjust interest payments and receipts can produce astounding distortions of incentives when the inflation rate is large. To illustrate, take the case in which the interest rate in the absence of inflation is 2 percent, and suppose that with an inflation rate of 13 percent an interest rate of 15 percent prevails. Consider now the price today for which a dollar of real purchasing power 25 years hence can be bought by lending (or sold by borrowing) at compound interest. Column 1 of Table 5 shows how the price varies with the tax rate on interest in the absence of inflation. Thus, for example, if interest is taxed at 30 percent, the saver receives a net of tax interest of 70 percent of 2 percent, or 1.4 percent per annum. According to Table 5, $.70, invested at 1.4 percent, will grow to $1 in 25 years.

Table 5

Illustration of the Effect of Inflation on the Price (via Borrowing or Lending) of a Dollar Purchasing Power 25 Years Hence

Individual tax rate on interest	No inflation or inflation plus adjustment of interest for tax purposes	13 percent annual inflation and no adjustment
(percent)	(................dollars	.................)
0	.61	.61
15	.65	1.06
30	.70	1.87
50	.78	3.96

*Entries show the present amount one would have to set aside at compound interest to obtain one dollar (in present purchasing power) 25 years hence. In the illustration the interest rate with no inflation is assumed to be 2 percent; with inflation at 13 percent the interest rate is assumed to be 15 percent.

The figures in column 1 also apply in the case of inflation if interest payments and receipts are adjusted for tax purposes by subtracting out the 13 percent inflation premium. Thus, while nominal dollar amounts after 25 years are much larger, the real purchasing power obtained is the same as with no inflation.

Column 2 of Table 5 shows the price without inflation adjustment. Prices in excess of $1 in column 2, which occur for all tax rates shown above zero, reflect the fact that, in the absence of inflation adjustment, the after-tax rate of interest is negative under the illustrative conditions. For example, a saver in the 50 percent bracket receives 7.5 percent per annum after taxes, in nominal terms. This implies an annual loss in purchasing power on the amount loaned of 5.5 percent per annum. Small wonder that high bracket taxpayers are heavy borrowers, rather than lenders, under those terms. An individual with a tax rate of any significance suffers an extraordinary reduction in the incentive to lend (and increase in incentive to borrow) in the presence of high inflation, unless an adjustment is made in the taxation of interest received or the deduction of interest paid. Unfortunately, while this adjustment is a necessary part of a consistent income tax, its implementation is far from simple.

The Cash Flow Tax requires no special adjustment of interest for inflation, since interest paid or received outside of qualified accounts is totally ignored for tax purposes. Interest paid or received via qualified accounts is simply part of the total return, taxed on withdrawal and credited on deposit, on a cash flow basis. No inflation adjustment is necessary as far as measurement of the tax base is concerned.

These are important instances, in which the Cash Flow Tax provides very simple rules whereas the Comprehensive Income Tax presents formidable implementation difficulties. Many others can be found in Table 4.

Let me conclude with one or two remarks about current reform discussions.

The first is that almost none of the proposals under serious discussion satisfactorily deals with what I have called the problem of achieving consistency. Most plans (including for example, those of Bradley-Gephardt and Kemp-Kasten) make no effort to solve the key consistency problems I have noted:

- They do not attempt to correct the income measurement system for the effect of inflation. I hope my illustrative examples have suggested the great importance of this problem. Even moderate rates of inflation can wreak substantial mischief with income type taxes.

- None of the plans deals with the problem of integrating the taxation of corporations and individuals. As a result, the plans will fall far short of achieving the degree of rationalization and simplification of the system that should be our objective if we are to go through the stress of fundamental tax reform.

o None of the plans deals with the vexing problem of realization accounting for capital gains. The result is that the system is certain to continue to be plagued by complex rules and arbitrary distinctions.

An exception to these remarks is the Hall-Rabushka Simple Flat Tax, which has been introduced by Senator DeConcini. Unlike the other plans, the Simple Flat Tax does represent the result of carefully thinking all the way through to a logically consistent system. The consequence, as anyone who has looked at the plan will know, is a rather remarkable degree of simplicity. No doubt, the simplicity would be less in practice than is claimed in theory, but I am certain that the essential elements of a very simple system are there. Not coincidentally, the Hall-Rabushka Simple Flat Tax is based on cash flow accounting, and is of the consumed income type.

The Hall-Rabushka plan has been criticized for being insufficiently progressive. While the figures I have given in this testimony support this view, it should be conceded that the facts on this matter could use further attention. But if it is determined that the basic structure of the Simple Flat Tax is desirable, it is clear that a different structure of rates including perhaps a system of graduated rates applied to compensation element of the system, could markedly change the degree of progressivity.

A more important point is that the basic consumed income strategy could be applied in many different ways. The critical elements involve revising the treatment we have come to look for in an income tax of interest payments and receipts, investment expenses (changing the treatment of depreciation) and capital gains. Almost any of the income type plans--and this explicitly includes the Bradley-Gephardt and Kemp-Kasten plans--could by a small number of changes be converted to taxes of the consumed income type. In my view, this is the strategy offering the best hope for a tax system that is simple, fair, robust against variations in the rate of inflation, and defensible against erosion in the long run.

Mr. Pickle. Now we will welcome Professor Halperin, our old friend, professor of law at Georgetown University Law Center.

STATEMENT OF DANIEL I. HALPERIN, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER (FOMER DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY)

Mr. Halperin. Thank you, Mr. Pickle.

I have been asked to concentrate on the question of why we continue to have large gaps in the coverage of the income tax; in effect, why we have not as yet adopted the type of bill that Professor McDaniel discussed.

In my written statement, I focus on that question. I will try to deal with parts of it as I speak today.

Let me say in contrast to the previous speaker, I continue to favor an income tax, with as broad a base as possible and with some degree of progressive rates.

I believe quite strongly that a consumption tax is less equitable, if not in theory then certainly in practice it will work out that way. Perhaps that is a matter of a value system or taste rather than something one can demonstrate objectively.

I think also it is likely to be more complex for the rank and file and has serious problems of transition which will make it awfully difficult for a consumption tax to be adopted. And I don't think it can be demonstrated that if we want to increase savings in society, overall savings, that that is the most equitable way to achieve that goal.

So I think the arguments for it does come down pretty much to what Mr. Bradford has said. He is suggesting that a consumption tax will be simpler for investors and businesses and it will be more neutral across investment.

I think it is important to examine the reasons why that suggestion is made. What he is saying is that the complexity of an income tax, a large part of the complexity of the income tax, in any event, results from the difficulty of measuring income from capital.

Despite all the complex rules that we have in the law today, which attempt to achieve that goal, we don't get it right, and, therefore, we have varying rates of tax types of investments. The tax law is not neutral, and it creates a distortion in investment choice which hurts overall growth.

The solution that is advocated is basically to say let's tax all investment income at zero, or let's not tax investment income at all and put the entire burden of the tax on labor income.

It is obviously always simpler not to tax than to try to work out a tax system. But I don't believe we have yet reached that point. I don't think we have exhausted the possibilities of the significantly improving and moving toward more neutrality and simplicity in an income tax, and I think we ought to first try more research, more imagination, more will, and not surrender at this point.

Furthermore, I think it is often not pointed out, and this goes back to Professor McDaniel's testimony, that a good deal of the complexity in the present income tax and the different tax treatment among various investments is not a result of mechanical problems, it is not because the technicians could not get it right, but it is a result of an intention to have different tax results for different industries.

It is not so clear to me that we are ready to have the same rate of interest paid by State and local governments as would be paid by corporations or limit the special treatment for research, the oil industry or real estate.

We have a lot of negative taxes today in the sense that some industries would be worse off if the income tax was repealed. And that tells me that zero is not the bottom rate.

And, therefore, I think there is no reason to generally believe that moving to a consumption tax which would have a zero rate of tax across-the-board will eliminate the distinctions.

If Congress is not able to resist claims for special treatment or to shift people who assert they need special treatment to the expenditure side of the budget, then the consumption tax will retain much if not most of the complexity of the income tax.

On the other hand, if we can solve those problems on the consumption tax side, I think we can also solve them on the income tax side. So, therefore, a lot of that argument, I don't say all of it, but a lot of the argument that we will have a simpler and more neutral system under a consumption tax is not based upon a difference between an income tax and a consumption tax but just a matter of political will or the decision we do not want to favor one particular investment over another.

As noted earlier, a lot of the reason we have a complex income tax today has to do with the fact that we run an expenditure system through the income tax program. And there are some problems with doing that.

IRS spends a lot of time worrying about whether expenditure programs make sense, and there is not the time and energy to think about whether the income tax system can be improved. We also have expenditure programs that are not very sensible because you run them through the income tax.

We give larger incentives for certain types of expenditures like home ownership or charitable contributions or buying savings for requirement to people at the higher brackets rather than the lower. It is as if you have a 50-percent-off sale for some people and a 10-percent-off sale for somebody else.

Also significant, on the investment side when you run an incentive program through the income tax system, you don't give the same subsidy to everybody.

We give different subsidies to people depending upon their bracket. And the result of that is either windfalls for people in the higher brackets or it drives the lower bracket people out of the business.

And if they are not going to get out of the business, then they have to find ways to get the tax benefits shifted to somebody else. And that leads to leasing and other efforts to shift the subsidy. Those kinds of complexities just don't exist if we run an expenditure program through the appropriations system, through loans and grants, and therefore we would have significant overall simplicity even if we kept every spending program we have today.

Now, what I did in my written statement, was to try to set forth the arguments that can be made for less than complete coverage and what the answers to those arguments might be.

I think it is important to remember, however, just because there are valid arguments doesn't mean all the provisions that we now have in the law can be justified. I think we can make a significant advance in simplicity if we keep in mind the purpose of special treatment—when people come in and ask for new extensions—to really think about whether it applies to the new situation, and require people to demonstrate what the connection is between the present tax system and the kind of incentive to particular behavior that they think is desirable.

Often we hear nothing other than I have a problem, it would be nice if taxes were lower, and, therefore, you ought to make them lower. Lots of times we have situations where there is no connection between the tax benefits sought and the supposed problem that exists.

In addition, I would say that if we are treating investment income specially because we think that a tax on investment income inhibits investment and growth, as Professeor Bradford suggested, then we ought to concentrate on whether that is the overall impact of all these special provisions.

Lots of people would say whether that is a good goal or not, when we look at all the distortions we now have in the present system, overall we have hampered investment and growth and we would be better off with a complete, full income tax.

Also, when we come to measurement problems, I think it is important to note that a lot of times we have sort of a catch-22 situation. We have situations or particular types of transactions that only exist because of the existing tax benefits and we say we cannot tax them correctly because it is too hard to measure income.

Well, those investments will disappear if we taxed them correctly, so we don't need to worry about that problem. Often it is true, particularly in the fringe benefit area, that there is an assertion that people are taking their pay in certain ways and that what they receive in kind they would not pay full market price for, therefore if we tried to tax them at full market, it would be unfair.

The only reason they are taking things which they don't value at full market in many cases is because $70 tax free is better than $100 when you have to pay tax of 50 percent.

If we tax both the $70 and the $100, they would prefer the $100, and the measurement problems would disappear. So I think in a lot of situations we have to ask ourselves why are there measurement problems, and are we creating the measurement problems in effect because we have a special system.

I would agree with the suggestion of Professor Bradford that a lot of times measurement problems will exist with respect to sound transactions. And the particular issue that he referred to is the accrual of gains on a year-to-year basis.

An income tax system which doesn't tax those gains is going to be inequitable as between people who hold investments that increase in value and others who do not. It is going to be inefficient in that it will favor particular types of transactions, for example, holding on to your existing investments.

We don't move in the direction of trying to tax accrued gains because we think it is too complex to do it or perhaps because we believe the public won't understand it, and therefore, we end up saying we have to ignore the problem under an income tax.

It is not so clear to me that is the right answer. When one thinks about the gains in efficiency and equity, maybe it is time that we thought seriously about whether certain gains can be taxed as they accrue.

We have done it in the area of straddles. Apparently without much in the way of complaint or difficulty. And perhaps we can begin to expand on those provisions.

Even as to complexity, while there is certainly some difficulties in trying to tax accrued gains, when one thinks about the number of provisions in the code that we can get rid of, the number of provisions in the code that are there solely because we don't tax gains annually—all the reorganization provisions, the like kind provisions, all kinds of things, special treatment of capital gains, perhaps, all based on and needed because we don't tax gains when they accrue.

So simplicity is certainly possible there as well. Generally this shows that we ought to look at both sides of the question. Lots of times we seem to focus on the people making arguments for special treatment, without looking to the damage to the system that is caused if they get their way.

And very often that damage is going to be much more significant than any potential benefit. We are going to have other people come in and ask for the same treatment, we are going to have to draw a fence around the good guys to keep the bad guys out of it.

We are going to have an enormous amount of complexity from that. So I think if we focus both ways, we are on the road toward having a simpler and more netural system.

Thank you.

[The prepared statement follows:]

STATEMENT OF PROF. DANIEL I. HALPERIN, GEORGETOWN UNIVERSITY LAW CENTER

Mr. Chairman and members of the committee, my name is Daniel Halperin. I am a professor at Georgetown University Law Center and I have previously served as Deputy Assistant Secretary of the Treasury for Tax Policy.

I favor an income tax with as broad a base as possible and with progressive rates. I believe over time, as we develop the understanding and the will to proceed, this is the road to the fairest tax system, outweighing any potential gains in efficiency or reduction in complexity which, it is argued, may be achieved by a consumption based tax.

I will not here directly detail the reasons for this conclusion. Rather I have been asked to discuss why the goal described above has to this date not been achieved—Why the income tax is full of gaps which belie the words of section 61 of the Internal Revenue Code that it reaches "all income from whatever source derived."

This is a subject that has been discussed many times, including in a number of excellent pamphlets prepared by the staff which I am sure will be available to the Committee. The feeling that one cannot possibly say anything new is inhibiting. All I can do is to describe the issues in my own way with the hope of adding to the discussion and contributing a little to the overall understanding of the question.

We can all agree that the tax system should be fair, should interfere as little as possible with the economy and should be as simple and as administerable as we can make it. Of course, not all of us would give the same meaning to the concepts—equity, efficiency and simplicity. More important, these worthwhile goals are often in conflict. Gaps in the coverage of the income tax can be blamed on arguments that broader coverage would be less efficient because it would inhibit investment and growth.[1] Efforts to include some types of benefits in the tax base have been thwarted by claims it would be too complex to measure the income and, perhaps, would not be well enough understood to be workable for what is largely a self-assessed tax. On the other hand, the biggest holes in our income tax come from provisions which can be said not to be a true part of the tax system at all. Rather these gaps can be traced to subsidies designed to direct investment, savings, wages or consumption to particular forms for what is said to be important social or economic goals. Here broader coverage requires either a determination that such subsidies cannot be justified in light of competing demands for government expenditures (or at least would not be justified if overall rates were reduced) or that aid can best be accomplished by other government programs outside the tax system. As discussed below, there are substantial reasons to choose the latter route if it is determined to continue a subsidy, but it is important to recognize that if this step is envisioned base broadening will produce less revenue (for rate cuts or otherwise) than it otherwise might.

What comes next may suggest to some that the road to a comprehensive income tax is not without stones or even a few boulders. There are, however, offsetting gains in reducing complexity and increasing efficiency which are all too easy to ignore. Further, tax system is without difficulty. In addition, by indicating that some serious arguments can or have been made to justify special treatment, I do not mean to imply that all of the existing exemptions have been so justified. Often the proponents of special treatment seem to say no more than "I have a problem and it would be nice if taxes were lower." Frequently there is no connection between the two or, if there is, it is insufficiently demonstrated.

For example, the complex special tax treatment of "Incentive Stock Options" is motivated by a desire to take advantage of the fact that accountants will permit different treatment for income statement purposes of two essentially similar transactions merely because the tax law treats them differently. Proponents of this provision can hardly be said to have been suffering from an undue tax burden because they insisted that if the incentive stock option provisions were adopted they would pay more taxes. They asserted that if there were clamoring to do so, why should anyone care.

More often of course, the special treatment sought will clearly reduce taxes but this does not necessarily mean that "high taxes" was the source of the claimed difficulty. A great deal would be accomplished if this Committee would merely insist that such a connection be established and upon a demonstration that the proposed change in tax treatment would be responsive to the problem. It is also important to recognize, as noted several times below, that any exemption will inevitably lead to others as well as to the inherent complexity of drawing a line around the favored transaction.

I will turn first to a discussion of why income from capital is not more fully subject to tax. This will be followed by a consideration of income labor and expenditures for consumption. Finally, I will conclude with a brief reference to ability to pay.

INCOME FROM CAPITAL

1. Introduction

The gap in the taxation of income from capital has a number of complex interlocking causes. Some believe that a complete exemption of investment income would maximize growth to the benefit of all.[2] In other cases the special tax treatment appears to be intended to favor one investment—for example state and local bonds—over another. Finally, it may be asserted that taxpayers may be insufficiently liquid to pay tax or that the amount of income cannot be measured without an unacceptable level of complexity.[3]

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[1] Although, as we shall see, it is often asserted that differences in tax treatment among investments leads to distortion in investment which reduces the overall production of goods and services.

[2] It also may be argued that special treatment is not an exemption at all but merely an ad hoc means to offset the excess tax which is imposed because of the failure to index for inflation.

[3] Given the present Code and its growth one may doubt there is indeed such a thing as unacceptable complexity.

2. Taxation inhibits growth

Consumption tax advocates often argue that an income tax in any form is per se inefficient. Since the return from investment is reduced by the tax, it is said that people will be less willing to save and invest, adversely affecting the prospects for growth.[4]

Presumably people who so believe would favor an across the board reduction in the tax on capital income (as compared to income from services) thus moving part of the way toward a consumption tax. We have no such provision.

3. Special benefits

The motivation for the existing special treatment which invariably favors one form of investment over another is harder to discern. Some believe this preference is desirable. Other times, it seems like certain groups will favor any tax reduction, whether or not it seems to be sensible, on the grounds that it is the only train on the tracks and if you create more trains none will reach the station. Perhaps, some view it as a move in the right direction toward the ultimate goal of elimination of all tax on income from capital.

a. *Inefficiency of special treatment.*—However, equity aside, there are substantial costs in efficiency. Even the broadest based incentives—investment credit, accelerated depreciation and capital gain—still favor particular investments over others. In particular the ACRS system of depreciation has, according to the Treasury, created enormous differences in the effective rate of tax on various investments ranging from 37% in the case of services and trade to minus 11% on motor vehicles.

A differential rate of tax is clearly inefficient. In the absence of an income tax, investors will choose the activity that will produce the highest rate of return thus generating the most overall wealth. Activity A producing 10% will be favored over Activity B with a 7% return. If taxes do not cause a change in the pattern of investment, wealth will not be reduced. All that happens is that a portion is taken off the top to finance goods and services provided by government. However, if taxes vary so that A is taxed at 50% and B is untaxed, investors will choose B with a 7% private return over A which generates a total of 10% but which requires that 5% be allocated to government. Thus, overall wealth is reduced.

These inefficiencies must override any benefit from reducing the overall burden on capital. If this is the goal, an across the board rate-cut or one limited to capital income seems clearly better. Those who deplore the lack of neutrality but do not oppose special treatment seems, to me at least, to be misguided.

b. *Arguments for special treatment.*—So far, however, I have assumed that neutrality between investments is desirable. It is not clear that everyone agrees. Should the cost of borrowing be the same for the States as it is for General Motors or should local government be provided with a lower rate of interest. What about the special incentives for investment in oil, real estate or agriculture or for research and experimentation. Some appear to believe that the current special treatment represents an effort to reduce or eliminate the tax on income from these sources. Thus, the pressures for a preference would disappear if the overall tax rate were reduced to zero. I personally doubt it and the fact that many industries now enjoy a negative rate of tax [5] confirms this belief. Therefore, in order to have a more comprehensive tax, Congress must either be prepared to resist these pressures or to shift the applicants to the Appropriations Committee. If it will do neither, a consumption tax will retain much if not most of the complexity of an income tax.

c. *Tax Subsidy v. Direct Grant.*—I expect other witnesses will concentrate on describing the pros and cons of direct grants or loans as opposed to tax reduction as a way of subsidizing investment activities but I wish to make one point here many.[6]

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[4] As you will hear from others, many disagree. They argue that these effects, if they exist at all, are not large and, in any event, there are other more direct and equitable means of increasing savings if there is a consensus that we should do so.

[5] In other words if the income tax were repealed the return from a particular investment would be reduced.

[6] The division of control over and responsibility for programs in both the Administration and Congress when substantive programs are run through the tax system, as well as the involvement of officials without sufficient expertise or interest in the goals of the program, are clear detriments. One hears arguments both ways about the virtues of entitlement programs as compared to individually reviewed grants but whichever is preferred should not depend upon the method of delivery. I understand the argument that the delivery system, the Internal Revenue Service, is already in place when the tax system is chosen but the costs of using that route are often ignored. The IRS is asked to administer another program without additional resources causing neglect of its true mission. The ability to focus on and improve the tax system itself is severely compromised as is the public's understanding and acceptance.

In a free market system one can expect the rate of return after tax to be equal across investments. Thus, if a subsidy is provided, more people will engage in activity B described above,[7] causing prices to fall and the rate of return to drop towards 5%.[8] This process does not, however, work as well with a tax subsidy. Subsidies delivered through the tax system will cause a drop in the rate of return equal only to the taxes saved by the investor with the lowest marginal rate.[9] Higher bracket investors will enjoy a windfall or put another the tax payable is reduced by more than the reduction in pre-tax return. This windfall can disappear only if all investors are in the highest bracket. But if this occurs, in a business activity, either lower bracket people have been forced out of business or they have found a way (by leasing or otherwise) to shift tax benefits to those in higher brackets. So whether or not the special subsidy is viewed as inefficient or a worthwhile incentive, use of the tax system leads, probably, to inequity and almost certainly to further complexity.

4. *Unrealized gains*

One of the largest gaps in the taxation of investment income—the failure to take account of the increase in value of assets—has other causes.[10] Perhaps, for this reason it does not qualify for the tax-expenditure budget. Some would deny there is income at all—"what went up may come down." This assertion is plainly wrong. One who receives 1,000 shares of AT&T (or even stock in a closely held company) from his employer as compensation for services is taxed on current value even though the stock is not turned into cash or, admittedly, can fall in value in the future. When stock purchased for $1,000 subsequently increases in value to $1,500, there is just as much new value or income as there would be if stock worth $500 were received from the employer.

I take more seriously the claim that a tax based on increases in value would be to difficult to administer or may require a tax payment when a taxpayer lacks the cash to pay. However, here again these arguments do not prevent treating stock received as compensation as income.

It must also be recognized that once it is determined not to base the tax on increase in value, it is very difficult to determine the proper time to tax. It seems unfair to impose the tax just because—e.g. a parent transfers property to a child or stock in an acquiring company is received in a corporate reorganization. Further, imposing tax on reorganizations (or sales for that matter) may inhibit economically desirable transactions if a tax can be avoided only by continuing to hold the original investment. Therefore, certain exchanges of "likekind" property are not taxed. But this leads to the claim that a taxpayer who sells for cash and reinvests the proceeds, perhaps in like-kind property, should be similarly treated. Some justify the significantly lower tax on capital gains as a means of providing more equal treatment between holders and sellers. So-called "rollover" rules have been pressed for years without success until the 1984 Act provision relating to the sale to an ESOP. The gain on such a sale is not taxed provided only the seller buys certain property which can include a portfolio of listed securities.

The point is that once the first step is taken—no tax on accrued but so-called unrealized gains—it is very difficult to know when to stop. Many others can make claims to be similarly situated but as the favored group expands it aggrevates the unfairness to those who are left behind—the wage earner who is taxed on his salary regardless of whether it is received in cash or property. The inequity is compounded by the ability to borrow against appreciated property and obtain cash, perhaps for consumption purposes, still without recognizing gain and by the fact that if the property is held until death, the gain is never taxed.

On the other side, taxpayers whose assets have depreciated may not be able to take account of such losses in measuring their income. In some cases this is true even though the property is sold or otherwise disposed of. Others, however, are able to pick and choose and by disposing of property which has declined in value reduce their taxes even though their total property has greatly appreciated. The ultimate ploy in this direction was the straddle—one investment which overall had a relatively minor risk of loss or opportunity for gain compared to the potential large loss on one leg (realized) matched by a large gain on the other (unrealized until a future year). If you bet a large sum on both teams to win a football game, you will have one big loss which in no way represents the overall result of the bet.

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[7] See p. 6.

[8] Note that despite the fall in rate of return, activity B will still be more attractive than it would be in a tax neutral world since it earns as much as A does after tax. Taxes have moved investors from A to B.

[9] The rate of return on tax-exempt bonds is not affected by the tax savings achieved by a 50 percent bracket investor.

[10] Perhaps similar concerns allow the gain even when assets are sold to be reported (on the so-called installment method) only when cash is received or allow certain taxpayers to use the cash method of accounting.

Of course, if this activity were allowed to continue, self-help would have led to repeal of the income tax. Therefore, we have had complex legislation in 1981 and 1984 which essentially takes account of unrealized gains.

Some say the way out of this dilemma is a consumption tax. Since a consumption tax does not tax income from capital, it need not worry about gains realized or unrealized. It is, of course, always simpler not to tax than it is to tax, but I do not believe we are that desperate. We should recognize the enormous simplification which can potentially follow from taxation of at least some gains as they accrue (we would no longer need to determine whether a realization or recognition event has occurred) in evaluating the overall complexity of such a change. Difficulties could be mitigated by exempting certain assets from the accrual rule and aiding those with serious liquidity problems. I call for research, not surrender.

Similarly, my research in the area of compensation suggests to me that there may be ways to retain the cash basis of accounting for employees and others while limiting the tax advantages now obtained from such use.

COMPENSATION

There appear to be a number of reasons for the tax gap related to income from services. In some situations there may be a public perception that the benefit received by the employee (e.g., certain discounts or business travel and entertainment) are not intended to be compensatory and therefore are not income. Benefits received in kind—again primarily the free use or purchase at a discount of products and services held for sale to customers by the employer or on-the-job travel and entertainment—may be difficult to measure. In certain circumstances—health, life insurance, retirement—a tax subsidy is provided in order to encourage consumption of these items by lowering their price. Finally, I believe there may be an unstated desire to compensate for the failure to fully tax income from capital by similarly excluding a portion of labor income from the base. (This is explicitly provided for by Kemp-Kasten H.R. 5533 § 121.)

1. Perception and measurement

This Committee has recently struggled with the problems of perception and measurement in connection with what used to be called non-statutory fringe benefits. As stated more fully in a forthcoming article,[11] I believe a case can be made for special treatment for use of employer product where the amount the employee would pay meets three criteria.

1. It is more than the employer's marginal cost of production.
2. It is more than any other available buyer would pay.
3. It is less than the market price of the goods.

Even in these circumstances the value attached by the employee should be included in income. The failure to do so may be inequitable and it is likely to lead to distortion in both labor markets and consumption choices. Measuring this value and allocating amounts to particular employees may be difficult but as the 1984 Act demonstrates an alternative excise tax imposed at the employer level may serve as a substitute.[12] In sum, I believe that the 1984 legislation continues to leave gaps in the taxation of these items.

In addition it has been generally accepted that the benefits from so-called working conditions should not enter the tax base. A serious question arises, however, when the supposed working condition involves participating in activities that may be enjoyed in similar circumstances off the job. To me exclusion of these benefits is not consistent with a system that purports to tax income from "whatever source derived." Such activities include sports events, theatre, night clubs, expensive meals and travel to vacation areas. It may be a question of perception—on the job benefits are not income. Even if one generally believes this, concern exists that the claimed business benefits are illusory or at least exaggerated. It may, however, be difficult to measure the benefits and allocate them to particular individuals.

It would help to keep these issues separate, however. If it is believed that ideally these items should be included in the base, problems of measurement and allocation can be alleviated by making a conservative estimate and imposing a special excise tax at the employer level.

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[11] National Tax Journal, Volume XXXVIII, No. 3, Sept. 1984.

[12] See Tax Reform Act of 1984, section 531(e) adding section 4977.

2. *Incentive*

Special tax treatment—exemption or deferral—for compensation received in certain forms can, as noted above, be viewed as an incentive to direct consumption to that item by lowering its price just as any business expects to increase sales by running a sale. It is important to recognize that if the IRS sponsors a sale it has a peculiar quality—the price reduction is not the same for all. It is 50% off for those in the highest bracket, 11% off in the lowest bracket and the regular price for those whose income is too low to pay taxes. It seems likely, therefore, that if the benefit were available with respect to individual purchases of these items if would have less effect on those people who would seem to need the incentive the most—the lower income. Presumably, directing the incentive to employer sponsored programs, particularly with the further requirement that the program not discriminate in favor of the higher paid, is apparently intended to achieve more widespread use than would result from individually available tax deductions or credits.

This raises a number of questions? To what extent is coverage dependent upon the favored tax treatment. How much life insurance, medical insurance, disability coverage, etc., would exist anyway? Would any decline in coverage that followed the removal of tax benefits be viewed as requiring government intervention to replace it.[13] Could a direct program do the needed job more cheaply and efficiently?

I do not know the answers to these questions and I am not aware of any research which seeks to find these answers. I would note, however, that my consideration of the issues surrounding the cafeteria plan controversy has led me to conclude that there may be a feeling that the tax subsidy is not particularly effective, at least as to some benefits, or even if it were that many would find large differences in tax merely because one person spent more on particular items than another unacceptable.[14]

3. *Tax reduction on labor income*

The apparent greater acceptability of special tax treatment for benefits that are desired by most employees (as opposed to those which have limited use even if usage is fairly even across income classes) sugests to me that possibility that the benefits are being viewed as a means of excluding a certain portion of labor income from tax (or achieving a reduced rate of tax on labor income). With some of these benefits, certainly medical care and perhaps group life insurance and prepaid legal (as opposed to pensions or profit-sharing plans), the implied tax reduction would appear to involve a greater percentage of tax liability (although not dollar amount) for those at the lower income end. If this is the goal, it would certainly be better if it were achieved directly without the requirement that consumption choices be changed. More important perhaps, changes in this area can be viewed as increasing inequity unless substantial advances were made in the inclusion of capital income in the base. If a consumption tax were adopted or other changes were made to reduce the burden on capital income, there would certainly be more resistance to a narrowing of the benefits on the labor side. Under a consumption tax, the shift in tax burden to labor must occur, of course, but it may have to be more hidden.

4. *Qualified pension plans*

This item should command special attention for two reasons. One, the large amount of money involved. Two, unlike other areas of compensation, tax savings are more heavily tilted to the upper end of the income scale.

Essentially the benefit here can be viewed as exemption of investment income from tax, exactly the goal sought by advocates of a consumption tax. Some may, therefore, view the tax treatment as generally appropriate, at least if it is limited to savings for future consumption as opposed to passage to the next generation. In any event, under the existing income tax, the tax exemption is reserved for so-called non-discriminatory plans, those that benefit a broad cross-section of employees. This tells me that we are trying to buy more retirement protection for rank and file employees since Social Security alone would not permit maintenance of the pre-retirement living standard and substantial individual savings are not likely.

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[13] In the case of medical insurance, many would view reduction in the scope of existing policies as a positive, not a negative, factor.

[14] The cafeteria plan debate also sharply focuses the question of why, for example, medical insurance provided by the employer should be treated more favorably than an individually purchased policy. In my mind the only explanation can be the former will produce more widespread usage by the low and moderate income. Yet I find unwillingness by many to recognize the need for a nondiscrimination test based on use rather than availability. This is probably not a unique example of special treatment being expanded without regard for the roots of or the justification for the original exemption. Many do not appear to see the need to even ask that question.

However, we seem to lose sight of this goal. The amounts that can be set aside for the high income would clearly exceed the level of income for which any sort of government aid can be justified. More important, the special benefits can be available for plans that do little for rank and file employees. Here again more concentration on the reason for special treatment is clearly desirable.

CONSUMPTION

Tax subsidies to target consumption by an implicit price reduction are not limited to the receipt of compensation in certain forms. There are also incentives for charitable contributions, home ownership (deduction for property taxes and mortgage interest) and home insulation (here it is a tax credit). As noted above,[15] the price reduction in the case of a tax deduction is not even across the board but can range from zero to 50%.

Recognizing the difficulty of justifying such an upside down consumption incentive, many would urge a change to a tax credit in lieu of a deduction for some of these benefits. A credit means an equal price reduction for those that have sufficient tax liability. This still leaves the question of whether any subsidy is consistent with the claims on government revenue. The issue can be avoided if another argument can be made for the special treatment.

Some would suggest that the tax base should not include expenditures on other than personal consumption and this excludes, not only medical expenses and casualty losses as discussed below, but also charitable contributions.[16]

We may also encounter here the phenomena noted above that one tax exemption often begets another. If an individual invests in the stock market, he must pay tax and only after—tax amounts can be used to pay rent. If the stock is sold and the proceeds invested in housing, the return on the investment is used to provide in kind housing services. Such imputed income is not taxed. In order to permit the amount spent on housing to be tax-free for those who borrow to purchase their homes, a deduction for mortgage interest is required. Of course, the logical extension of this approach is to allow renters a deduction for a portion of their rent. Many have so urged but it has not happened. A movement in the other direction to include the cost of housing in the base requires taxation of imputed income. Measurement of such income would require an approximation but would not necessarily be unduly complicated. I think most would conclude, however, that the public would just not accept the concept.[17]

ABILITY TO PAY

I believe as noted at the outset that a tax based on income is most equitable because it best reflects ability to pay. Others will argue that a consumption base best reflects such ability or is the fairest as between those who desire to spend current income at different times. I'll leave that discussion as well as the issue of progressivity and the degree thereof to other witnesses but I may note that I believe it is a subjective judgment based on an individual's values, not mathematical formulas.

One might have to decide, however, whether certain expenditures not related to earning income reflect on ability to pay. For some of this justifies deduction for unusual medical expenditures or large casualty losses. You might consider, however, the difference if any between $10,000 spent on a trip around the world by those few who encounter rain everyday and $10,000 spent on a car by those few who suffer an almost immediate total loss. If you buy insurance for an additional $500 you protect against such loss but you have a more expensive product. Those who choose not to insure will on average achieve less enjoyment but they have spent less. Is this sound analysis? If so there is no casualty loss—you get what you paid for.

Ability to pay issues also arise in the context of assigning income to trusts, children or others. The question should be whether the circumstances are sufficiently changed so that the justification for progressive rates no longer applies.

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[15] See pp. 14-15 supra.

[16] It seems to me that charitable contributions do provide personal benefit. In many cases this is direct as charitable contributions are given to institutions—churches, museums, orchestras—patronized by the taxpayer. Nevertheless, I would not recommend elimination of the deduction. But I do feel strongly that accrued gains on properly donated to charity should be taken into income.

[17] Failure or inability to tax imputed income from services also leads to difficulty. A homemaker considering entering the labor force would be better off only if after-tax income exceeded the value (or cost) of the services in the home. This could be a significant deterrent and may be the best argument for a child care or second earner deduction.

Income splitting rules suggest that income should be deemed earned equally by both spouses. A deduction for alimony can be explained as a way of permitting income splitting after divorce or separation. If I am right about this, some of the restrictions on deductions in the 1984 Act do not make a great deal of sense.

CONCLUSION

One searches in vain for a way to summarize what goes before. Therefore, let me repeat here my opening comments on the approach recommended by Henry Aaron and Harvey Galper which will appear in an about to be released Brookings volume.

COMMENT BY DANIEL HALPERIN

I continue to believe that a broad-based progressive tax on income should be the long-range goal. It is decidedly preferable to a similar tax based on consumption.

1. To what extent is the complexity and lack of neutrality of today's tax system inherent in an income tax, as opposed to a reaction to political or other pressures for more favorable treatment of income from certain sources? If the latter is the governing cause, as I believe it most often is, should we not assume, in the absence of compelling evidence to the contrary, that these distinctions will continue under a consumption tax?
2. Is it equitable to completely exempt income from capital tax? If one does not agree with Aaron and Galper's claims for a consumption tax on equity grounds, as I do not, there are serious tradeoffs which require a strong showing that the supposed gains in simplicity and efficiency are significant.
3. Will a consumption tax be simpler for the average taxpayer? I believe not, owing to the additional complexity of dealing with investment, liquidation of investments, and borrowing.
4. Will it be just as difficult to accomplish the transition to a broad-based income tax as to a consumption tax? While there are difficulties with both, I believe the transition to a consumption tax presents problems of a different order of magnitude, which again should and probably will prevent its adoption in the absence of an overwhelming case in its favor.

In light of these benefits, I deplore the energy which is being devoted to the development of various forms of consumption taxation and the time devoted to its examination. The goal I believe I share with Aaron and Galper—a fairer, simpler, and more efficient tax system—would be better served if we would concentrate on improving the income tax. In particular, we need to examine more carefully the fundamental difficulties of measuring income from capital, properly emphasized by Aaron and Galper, before we conclude that the problems are so serious that we should stop trying.

Mr. PICKLE. And now we are pleased to hear from Mr. Sunley, who is director of tax analysis for Deloitte, Haskins & Sells, and was a former Deputy Assistant Secretary of the Treasury. He has appeared before this committee many times. We appreciate your presence here this morning.

STATEMENT OF EMIL M. SUNLEY, DIRECTOR OF TAX ANALYSIS, NATIONAL AFFAIRS OFFICE, DELOITTE, HASKINS & SELLS (FORMER DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX ANALYSIS)

Mr. SUNLEY. Thank you, Mr. Pickle.

I appreciate the invitation of this committee to present testimony on the general topic of tax simplification.

An important criterion for a good tax system is that the tax rules and tax forms are simple enough that the average taxpayer can understand how their tax liability is determined, and simple enough that the burdens of voluntarily complying with the tax law are not oppressive.

This requires that the tax law be clear, specific, and certain. But it also requires that the law have some discernible connections to a taxpayer's true economic situation. So, while the goal should be to have simple and clear rules for garden variety transactions, when people live complex economic lives, the tax law is also going to have to become complex if tax avoidance is going to be minimized. Moreover, the cost to the Government of collecting tax and the compliance cost incurred by the taxpayer should be minimized. Finally, the tax law should be sufficiently definite that tax collectors have little discretion about how much to assess taxpayers.

There is little disagreement that, other things being equal, a simple tax is preferable to a more complex one. The problem is that other things are rarely equal.

An important aspect of the complexity of the currrent income tax is how much the tax influences our day-to-day economic decisions. We must take taxes into consideration when we make decisions as to whether we want wage income or tax-free fringe benefits; whether we invest in dividend yielding securities or securities with capital gains potential; whether we put our savings into individual retirement accounts or some other vehicle; whether we give money to charity, go back to school for additional education, attend a foreign convention, or join a professional association. In short, tax laws influence our choice among sources of income and ways of spending it. To the extent that the tax base can be broadened and marginal rates lowered, taxes can be a less pervasive influence in our everyday economic decisions. This would greatly simplify our economic lives.

Our tax is complex for six reasons. First, if a tax is going to be imposed on income, it is necessary to measure net income. If a taxpayer's only source of income are wages and salaries, interest, and dividends, income is easy to measure. If the taxpayer is a business, to measure net income, expenses must be matched with the revenues to which they relate. Issues of timing must be addressed. This is particularly true if each tax year is considered separately and progressive rates are applied to each year's income.

I believe every member of this panel would agree that if the measurement problem was the only source of tax complexity, the income tax would be much more manageable than it is today. Most taxpayers would be able to understand both the tax law in the abstract and its application.

A second source of complexity of our tax law is the frequent changes in the law. As Congress continues to churn out a tax bill on almost an annual basis, taxpayers and tax practitioners must each time become familiar with the new rules. Tax forms must be rewritten, making it difficult for taxpayers to follow last year's forms when completing this year's. Business transactions must be restructured and taxpayers must decide whether to alter their investments, seek income from new sources or to revise their spending patterns. As one tax law follows another, the tax draftsman works under tremendous time pressures. He inevitably makes mistakes. Consequently, each new tax act is followed by technical corrections. And we have even had a technical correction to a technical correction.

In my prepared testimony, I illustrate the problem of frequent changes in the tax law by outlining the current uncertainty as to how the Deficit Reduction Act applies to company cars supplied to 5 percent owners. The committee report appears to contradict the statute. This contradiction probably was unintended and resulted from the shortage of time available for review of the statutory draft and the committee report language.

A third source of complexity is complex transition rules. When the tax law changes, Congress must provide transition rules because taxpayers have relied on prior law in structuring transactions. Grandfathering transactions entered into prior to the effective date, however, can produce some complex rules. Again, in my prepared testimony, I illustrate the problems of complex transition rules by examining the transition rules adopted for the new economic performance requirement for accrual basis taxpayers and looking at the old rule for the pre-1970 long-term capital loss carryforward.

A fourth source of complexity is that complex rules are added to the tax law to achieve only minor improvements in the perceived fairness of the income tax. I think averaging and the rule born in the 1976 act, which deprives four categories of taxpayers the benefit of the zero bracket amount, are illustrations of complex rules that may achieve only minor improvements in equity.

A fifth source of complexity is that we try to do too much with our income tax. The U.S. individual income tax—and the corporate income tax—is now incredibly complex in part because many exclusions, deductions, and credits have been added to the tax law to provide incentives for certain activities, or to relieve unusual burdens. These incentives or aids, often called tax expenditures, are substitutes for direct Government expenditures. Tax incentives provided through the tax system range from the broad-based investment tax credit to more targeted incentives such as the jobs tax credit and the FAST writeoffs for rehabilitated historic structures.

In general, tax expenditures are not inherently different from direct expenditures. In practice, though, tax expenditures tend to involve less Government control or redtape than direct expenditure programs.

Most taxpayers who lead simple economic lives do not have to contend directly with the complexity of the various tax expenditures. Nevertheless, they must wonder what tax advantage others can reap from some of the special exclusions, deductions and credits. This may very well contribute to the widely held view that, "My neighbor pays less tax than I do."

A final source of complexity results from the political process itself. What starts out to be a simple proposal can end up as an incredibly complex one. A Congressman may prefer "A" and the Treasury may prefer "not A." When a tax bill finally reaches the nut cracking stage, the Congressman and the Treasury compromise on something half way between "A" and "not A." Each side gets half a loaf, but the half loaf compromise is usually considerably more complex than either "A" or "not A."

An example of compromised proposals that have resulted in wildly complex tax law would include the special rules on foreign conventions, the 1978 rule tightening the treatment of Americans working abroad, and the credit for the elderly.

The average taxpayer probably gauges the complexity of the income tax not on the tax law itself, but on how the law is reflected in the tax forms. In fact, for many people tax simplification may mean making the forms and the tax rules simple enough that the average taxpayer can complete his or her return.

The middle section of my testimony examines the complexity most taxpayers face when completing their tax forms. And I would like to call your attention to only a few items.

I summarize on page 15 the number of individual taxpayers who have returns prepared by paid preparers. One thing I find interesting relates to the 1040EZ form; almost 4 percent of the EZ forms are now prepared by paid tax preparers.

We also note on page 17 of the testimony the number of returns that are filed which are 1040 returns, 1040A, and 1040EZ returns. There was a trend to increasing the number of taxpayers who were able to use the 1040A return. But this was accomplished by making the 1040A return somewhat more complicated.

Form 1040A used to be a half-page form—half-page form on both sides. It is now a two-page form with a two-page attachment. As a result, more taxpayers are eligible to use the 1040A, but then we introduced in 1982 a new form, the 1040EZ, for single individuals with no dependents.

I show on page 18 the number of items that were added to the 1040A return: The Presidential election campaign fund checkoff, earned income credit, taxable portion of unemployment compensation, two earner deduction, charitable contributions deduction, IRA contributions, and the credit for child care expenses.

In fact, if you look at the 1040 form itself, the long form, the form used by 60 percent of the taxpayers, many items had to be added to that form to reflect the changes in the law since 1970.

In fact, 13 of the 68 lines on the form 1040 are a result—a direct result—of legislation enacted since 1970.

Next, if you move over toward page 29 of the testimony, I look at the percentage of returns using itemized deductions and the percentage not using them. For taxpayers who use the long form, itemized deductions are a significant source of complexity.

A major thrust of the series of tax legislation that began in 1969 and continued through 1978 was to simplify the tax law for individuals by increasing the standard deduction, now known as the zero bracket amount, so that fewer taxpayers had to contend with itemizing.

In 1970, almost 48 percent of taxpayers itemized their personal deductions. In contrast, when the standard deduction was first introduced in 1944, less than 20 percent of the taxpayers itemized their deductions.

The increase in the standard deduction during the 1970's, decreased the number of returns with itemized deductions from 48 percent in 1970 to 29 percent in 1978, a significant simplification.

Inasmuch as the standard deduction or zero bracket amount has not been increased since then, the number of itemizers has been increasing, reaching 36 percent of all returns in 1983. I would point out to the committee that the zero bracket amount will be adjusted for changes in inflation beginning in 1985, so that the percentage of returns electing to itemize should not creep up in the future. But, it is much higher than it was just a few years ago.

To continue, if you look on page 33 and 34, I outline the tremendous growth rate of tax credits, a source of complexity for individuals.

On the 1040 form for 1983, there were a number of tax incentives provided in the form of tax credits. Six of these credits had separate line items on the tax return. Individuals were also permitted to claim three additional credits. But because space was so limited on the 1040, they were instructed to list other credits in the margin and include them in the total of all credits on line 48 of the 1040.

We have simply run out of room. If we go back 15 years ago, individual taxpayers had to contend with only two of these tax credits—the investments tax credit and the credit for the elderly, then called the retirement income credit.

Finally, in the last section of my testimony, I look at the various proposals for restructuring our tax system and comment on the simplification aspects of these proposals.

As you know, in his last state of the Union address, President Reagan called on the Treasury Department to provide recommendations for tax reform by late this year. Treasury is to study a flat rate tax, a tax on consumed income, a national sales tax, and the value added tax.

Deficit Reduction Act of 1984 also instructs the Treasury to study alternatives to the present income tax and to report to the Congress by the end of the year. This report is to include a study of tax shelters.

What implications do the various alternatives for restructuring our tax system have for simplification?

I believe that the widespread public interest in a flat rate or a broad-based low-rate income tax represents a yearning for a simpler tax. Lower marginal rates which can be achieved by broadening the tax base are a key to simplification inasmuch as lower rates will reduce the incentive value of the exclusions, deductions, and credits that remain.

But not all base broadening would lead to significant simplification. Dropping tax credits, deductions and exclusions that have little to do with measuring net income clearly would simplify the income tax.

However, as I indicated earlier, not all of these items involve that much complexity. For example, taxpayers generally can determine the amount of their big-ticket itemized deductions with little difficulty. Though the distinction between capital gains and ordinary income is a major source of complexity, even in a world with full taxation of capital gains, there would still be a need for some limitation on the ability of taxpayers to deducted realized losses against other income.

Thus, the distinction in the tax law between capital gain property and ordinary income property would remain. Also, taxing fringe benefits as we learned this past year, involves significant problems of valuation. Congress faced these problems by statutorily exempting from taxation the major fringe benefits that have evolved over the years.

Any fundamental reform of the income tax must treat three issues—capital recovery, the double taxation of dividends, and the impact of inflation. There are no easy answers to these vexing problems, but certainly answers can be devised that limit unnecessary complexity.

As I have noted, these three issues would not be a problem if Congress enacted a broad-based expenditure tax, sometimes known as a tax on consumed income.

A tax on consumed income, however, has its own sources of complexity. I would only point out in passing that many of the gains in simplicity from moving to a tax on consumed income would be lost if the individual States continue to tax income. This is particularly true if States continue to tax corporate income and absent a Federal tax to which the States can conform the laws of each State begin to diverge from one another.

A tax on consumed income is usually considered a replacement for the individual and corporate income tax. It clearly would not be a simplification to add that tax to the existing tax. But transactions based consumption taxes, that is to say, the value added tax and the retail sales tax are generally considered as additions to the current Federal revenue system.

Though either of these taxes are fairly simple compared to an income tax, adding one of them to our current Federal tax system can only increase the overall complexity of the tax system. Of the two, the retail sales tax is somewhat simpler in that only retailers are tax collectors.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF EMIL M. SUNLEY, DIRECTOR OF TAX ANALYSIS, NATIONAL AFFAIRS OFFICE, DELOITTE, HASKINS & SELLS

I am Emil M. Sunley, Director of Tax Analysis in the National Affairs Office of Deloitte Haskins & Sells, an international accounting firm. It is indeed a pleasure to respond to your invitation to present testimony on tax simplification.

An important criterion for a good tax is that tax rules and tax forms are simple enough that average taxpayers can understand how their tax liability is determined, and simple enough that the burdens of voluntarily complying with the tax law are not oppressive. This requires that the tax law be clear, specific, and certain. But it also requires that the law have some discernible connection to a taxpayers true economic situation. So, while the goal should be to have simple and clear rules for garden variety transactions, when people live complex economic lives, the tax law is also going to have to be complex if untoward tax avoidance is going to be minimized. Moreover, the cost to the government of collecting the tax and the compliance cost incurred by the taxpayer should be minimized. Finally, the tax law should be sufficiently definite that tax collectors have little discretion about how much to assess taxpayers.

There is little disagreement that, other things being equal, a simple tax is preferable to a more complex one. The problem is that other things are rarely equal. In fact, equity is often the enemy of simplicity. A poll tax is a very simple, definite, and easy to administer. But it is also contrary to most people's idea of fairness. Sales taxes are simpler to collect than income taxes, but this difference is rarely the grounds for choosing one over the other.

An important aspect of the complexity of the current income tax is how much the tax influences our day-to-day economic decisions. We must take taxes into consideration when we make decisions as to whether we want wage income or tax-free fringe benefits; whether we invest in dividend yielding securities or securities with capital gains potential; whether we put our savings into individual retirement accounts or some other vehicle; whether we give money to charity, go back to school for additional education, attend a foreign convention, or join a professional association. In short, tax laws influence our choice among sources of income and ways of spending it. To the extent that the tax base can be broadened and marginal rates lowered, taxes can be a less pervasive influence in our everyday economic decisions. This would greatly simplify our economic lives.

Today I want to outline the major sources of complexity in our income tax and where possible make some suggestions as to which unnecessary complexities could be reduced or eliminated. After focusing on these general sources of complexity, I turn to a discussion of how the complexity of the individual income tax is reflected in the tax forms. I also examine what has been done and what might be done to simplify the forms themselves. In the final part of my testimony I examine the simplification aspects of some of the major proposals for restructuring our tax system.

In my testimony I do not focus on the complexity of the income tax business. Let me add a word on that at this point. The complexity problems of small business are very similar to the complexity problems of individual taxpayers. Small businesses need to be able to understand the tax rules with minimal outside professional advice. They simply do not have the resources to get involved with an intricate tax law. To the extent small businesses must maintain two sets of books, the tax law is complex. Though at times Congress has considered simple rules for small business, such as simple rules for inventory accounting, Congress has had little success in developing simple rules that would not result in income falling through the cracks.

For large businesses, however, the complexity of the tax rules can be managed. When Congress enacts a complex set of rules, such as Subpart F, an additional tax professional can be hired to specialize in this new body of tax law. Thus, the problems of tax complexity for large businesses should be viewed more from the perspective of enforcement of the tax laws. Complex laws often give taxpayers wide latitude to take alternative positions on a tax return. Even with a team of revenue agents, the IRS may have difficulty in interpreting the rules enacted by Congress. This can lead to considerable uncertainty for the business taxpayer.

SOURCES OF COMPLEXITY

Our income tax is complex because we:

(1) must measure net income,

(2) change the law too frequently,

(3) adopt complex transition rules,

(4) often strive for minor improvements in equity,

(5) try to do too much with income tax, and

(6) ignore complexity when making political compromises.

Measuring Net Income

If a tax is going to be imposed on income, it is necessary to measure net income. If a taxpayer's only sources of income are wages and salaries, interest, and dividends, income is easy to measure. If the taxpayer is a business, to measure net income, expenses must be matched with the revenues to which they relate. Issues of timing must be addressed. This is particularly true if each tax year is considered separately and progressive rates are applied to each year's income.

Three of the most difficult areas of income measurement relate to capital recovery, inflation, and capital gains which as a practical matter can only be taxed when realized. These three problems would disappear if Congress enacted a broad based expenditure tax as advocated by some tax policy experts. Such a tax, sometimes called a cash-flow tax or a consumed-income tax, would, however, bring with its own problems of complexity. In fact, for many taxpayers, this new tax would be more complex than our current system. They would have to measure income first, including all borrowings, and then subtract from income all additions to savings.

If the measurement problem was the only source of tax complexity, the income tax would be more manageable than it is today. Most taxpayers would be able to understand both the tax law in the abstract and its application.

Frequent Changes in the Law

Frequent changes in the tax law are a major source of tax complexity. As Congress continues to churn out a tax bill on almost an annual basis, taxpayers and tax practitioners must each time become familiar with the new rules. Tax forms must be rewritten, making it difficult for taxpayers to follow last year's forms when completing this year's. Business transactions must be restructured and taxpayers must decide whether to alter their investments, seek income from new sources, or revise their spending patterns. As one tax law follows another, the tax draftsman works under tremendous time pressures. He inevitably makes mistakes. Consequently, each new tax act is followed by technical corrections. We have even had a technical correction to a technical correction.

Let me illustrate for you the problems of frequent changes in the tax law by outlining the current uncertainty as to how the Deficit Reduction Act applies to company cars supplied to 5 percent owners. The Committee Report appears to contradict the statute. This contradiction probably was unintended and resulted from the shortage of time available for review of the statutory draft and the Committee Report language.

Under the new law, if the business use of a car is 50 percent or less, the company gets no investment tax credit and the depreciation must be determined using the straight-line method over a five-year life. Except for 5 percent owners, personal use by an employee is treated as business use by the company if the company withholds on the fair market value of the personal use or the employee reimburses the company for the value of the personal use. However, a car provided as compensation for (or leased to) a 5 percent owner of a business or to a related taxpayer will not be treated as trade or business use. As a result, a company car provided to a 5 percent owner will fail the business-use test unless it is used more than 50 percent in the company's business.

But, must the company reduce its depreciation proportionately for any personal use by the 5 percent owner? The statute, the Deficit Reduction Act of 1984, does not require a reduction nor does it change prior law in this respect. Example 2 on page 1029 of the Conference Report, however, suggests that a reduction in depreciation is required. This example is supported by additional language on page 1026 of the Conference Report. The staff of the Joint Committee on Taxation and the Treasury have indicated informally that they agree that example 2 is misleading and the phrase, "not treated as a use in a trade or business," in the first sentence of the paragraph on page 1026 relating to 5 percent owners should have been "not treated as a qualified business use." Though that word change would appear to be very minor, for a tax practitioner it has great significance. The point, however, is that taxpayers and tax practitioners at present are uncertain as to what will be the tax treatment of an automobile supplied to a 5 percent owner.

In passing, it should be noted that the Deficit Reduction Act, by imposing withholding on the personal use of automobiles by employees, will increase the recordkeeping requirements and thus the complexity of the income tax. This is inevitable when the tax net is extended to cover in-kind benefits. Nevertheless, I believe the new rules are workable. The key open question remains what is the value of that personal use?

This example further illustrates the problems taxpayers have in complying with and reacting to a frequently changing tax law. In this case, it is most important that the Service provide early guidance on the valuation issue as companies will need time to gear up to increase their chargebacks for personal use or to institute withholding on the personal use of company cars. Many companies will want to adjust other compensation so as to offset the impact that the change in the law may have on employees' true after-tax income.

Complex Transition Rules

When the law changes, Congress must provide transition rules because taxpayers have relied on prior law in structuring transactions. Grandfathering transactions entered into prior to an effective date, however, can produce some very complex rules.

To illustrate, consider the new economic performance requirement for accrual basis taxpayers. Under the transition rules, taxpayers may use the new rules for expenses incurred under prior law after July 18, 1984, or taxpayers may elect the new rules for all expenses where economic performance occurs after July 18, 1984, with a three-year spread of any doubling up of deductions. The election can be made on an item-by-item basis, but what is an item? More importantly, most taxpayers did not close their books on July 18, 1984. Will the IRS permit prorating of July items, at least for items that cannot be easily identified. How should inventory be adjusted where premature accruals were included in the base year inventory?

The transition rules for economic performance apply only to business taxpayers and will last only three years. Some transition rules apply to non-business taxpayers and may last for many years. For example, since 1969 and until 1987, taxpayers with capital loss carryforwards must separate their pre-1970 long-term capital loss carryforwards from their post-1969 carryforwards.

Minor Improvements in Tax Equity

While the goal of equity is itself a source of complexity, too frequently complex rules are added to the tax law to achieve only minor improvements in the perceived fairness of the income tax. Let me illustrate with two examples.

In 1981, before the Deficit Reduction Act of 1984 tightened the rules, nearly 7 percent of individual taxpayers elected income averaging for a tax savings of just over 6 percent of the regular tax. Income averaging was adopted by Congress as a means of providing tax relief for taxpayers whose incomes fluctuate: because of the progressive rate structure, absent income averaging a taxpayer with fluctuating income would pay higher taxes over time than a similarly situated taxpayer with steady income. But income averaging has not only benefited taxpayers with fluctuating incomes; it has also benefited many taxpayers with rapidly rising incomes. More importantly, for every taxpayer who elects income averaging, there may be as many as three taxpayers who are eligible to elect income averaging but do not. Many of those who are eligible to elect but do not would have only a small tax reduction from averaging. But this is not true of all those who fail to elect. How significant is the improvement in equity when only 25 percent of the eligible taxpayers elect income averaging?

A second illustration is found in the rule born in the 1976 Act that denies four categories of taxpayers the benefit of the zero bracket amount (ZBA), and requires them to itemize their deductions. The most common instance is children who have passive income in excess of $1,000 and are claimed as dependents on their parents' tax return. In effect, a dependent child can only use the ZBA to the extent that he or she has earned income.

In 1981, just over 600,000 taxable returns, or less than 0.8 percent of all taxable returns, had unused ZBA, averaging about $1,900 per return. Yet the rule must be confronted by all dependent children, or more likely their parents. In the days when parents could loan money interest-free to their children, this provision at least prevented any passive income from accruing to the child completely untaxed. At best, however, the rule pushes the income into the next highest bracket, generally from the zero bracket to the 11 percent bracket. Does its contribution to improved equity justify this rule's existence and complexity?

Tax Expenditures

The U.S. individual income tax (and the corporate income tax) is now incredibly complex in part because many exclusions, deductions, and credits have been added to the tax law to provide incentives for certain activities, or to relieve unusual burdens. These incentives or aids, often called tax expenditures, are substitutes for direct government expenditures. Tax incentives provided through the tax system range from the broad-based investment tax credit to more targeted incentives such as the jobs tax credit and the fast write-offs for rehabilitated historic structures. In general, tax expenditures are not inherently different from direct expenditures. In practice, though, tax incentives tend to involve less government control or red tape than direct expenditure programs.

Most taxpayers who lead simple economic lives do not have to contend directly with the complexity of the various tax expenditures. Nevertheless, they must wonder what tax advantage others can reap from some of the special exclusions, deductions, and credits. This may well contribute to the widely held view that, "my neighbor pays less tax than I do."

Complex Compromises

A final source of complexity results from the political process. What starts as a simple proposal can end as an incredibly complex one. A Congressman may prefer "A" and the Treasury may prefer "not A." When a tax bill reaches the nutcracking stage, the Congressman and Treasury compromise on something halfway between "A" and "not A." Each side gets half a loaf, but the half-loaf compromise is usually considerably more complex than either "A" or "not A." Examples of compromised proposals that have resulted in wildly complex tax law would include the special rules on foreign conventions, the 1978 rules tightening the treatment of Americans working abroad, and the credit for the elderly. This credit, for example, is virtually impossible to compute for a married couple, with one spouse 65 or over and the other spouse under 65 with income from a public retirement system. It needs to be computed two different ways to see which one gives the higher credit.

FILLING OUT THE TAX FORMS

The average taxpayer probably gauges the complexity of the income tax not on the tax law itself, but on how that law is reflected in the tax forms. In fact, for many people tax simplification may mean making the forms and tax rules simple enough that the average taxpayer can complete his or her return. After a five year period of decline the percentage of individual returns that were prepared by paid preparers began increasing in 1982. Thirty-seven percent of individual returns were prepared by paid preparers in 1981, increasing to 41 percent in 1983.

Percent of Individual Returns
Prepared by Paid Preparers
by Type of Return
1980-1983

	1980	1981	1982	1983
All Individual Returns	37.9	37.3	40.1	41.2
1040 only	52.4	52.9	56.8	57.3
1040A only	16.9	14.9	22.1	24.3
1040EZ only	N/A	N/A	3.3	3.9

Source: Data from Taxpayer Usage Studies, as published in the U.S. Department of Treasury Internal Revenue Service SOI Bulletin, various issues.

For most individuals, computing the amount of income is not the major source of complexity. Instead, complexity comes from selecting the tax form, determining the filing status, computing certain adjustments to income, itemizing personal deductions, and determining allowable tax credits.

Selecting the Tax Form

The attached Appendix provides a brief summary of changes in the individual income tax forms over the past twenty years. In 1983, taxpayers had to choose among a very short form (Form 1040EZ), a short form (Form 1040A), and a long form (Form 1040). The following table shows the significance of each of these forms, as a percentage of total individual returns, since 1972.

Form 1040EZ was first introduced in 1982. It is available for most single taxpayers with no dependents. Taxpayers electing Form 1040EZ must have taxable income of less than $50,000 and their only sources of income can be wages, salaries, tips, and interest of $400 or less. 1040EZ taxpayers may not itemize their deductions and are not permitted to make any adjustments to income or take any tax credits. The 1040EZ is a very simple form and 14.8 million people used it in 1982. Even so, over 3 percent of those returns were prepared by tax preparers.

Individual Returns Filed
by Type of Return
1972-1983

	Total Number of Returns Filed (000)	Percent of Individual Returns		
		1040	1040A	1040EZ[3]
1983[1]	90,407	61.8%	21.1%	17.1%
1982[2]	95,298	62.4	22.0	15.6
1981	95,396	60.4	39.6	-
1980	93,902	65.1	34.9	-
1979	92,694	59.7	40.3	-
1978	89,772	60.0	40.0	-
1977	86,365	60.8	39.2	-
1976	84,670	66.2	33.8	-
1975	82,229	66.3	33.7	-
1974	83,346	73.2	26.8	-
1973	80,693	73.2	26.8	-
1972	77,573	72.3	27.7	-

Source: U.S. Department of Treasury, Internal Revenue Service, Statistics of Income Individual Income Tax Returns, various years.

1/ Based on Taxpayers Usage Study data as reported in the SOI Bulletin, Summer 1984. Number of returns represents about 95 percent of 1983 returns to be filed. The percentage of 1040 returns may be understated (and 1040A or 1040EZ overstated), as the 1040 returns may tend to be filed later than other, short form returns and this may be underrepresented (or overrepresented) in the sample.

2/ Preliminary data as reported in the SOI Bulletin, Winter 1983-1984.

3/ The 1040EZ was not introduced until 1982.

The short form, 1040A, used to be two sides of a half page. But as the law has changed, new items have been added to the 1040A Form so that more taxpayers can use it. 1040A is now a two-page form. There is also a two-page attached schedule which 1040A-filers must use if they have interest or dividend income over $400, claim a deduction for two-earner couples, or claim a credit for child care expenses. Users of Form 1040A may not itemize their personal deductions, and may make only certain adjustments to income and take only certain tax credits. In 1982, 21 million taxpayers used Form 1040A. Changes in Form 1040A since 1972 illustrate the increased complexity of the income tax for an average taxpayer:

Item	Year First Added
Presidential Election Campaign Fund Check-Off	1973
Earned Income Credit	1975
Taxable Portion of Unemployment Compensation	1979
Two-Earner Deduction	1982
Charitable Contributions Deduction	1982
IRA Contributions	1983
Credit for Child Care Expenses	1983

The long form, Form 1040, was used by 59.4 million taxpayers in 1982, more than 60 percent of all individual returns filed. Taxpayers not eligible for either of the "simpler" forms must use the 1040. In 1983, the Form 1040 package included 10 schedules the taxpayer may use. To complete the Form 1040, many taxpayers had to obtain additional schedules such as Form 3903 or 3903F for moving expenses, Form 2106 for employee business expenses, or the separate forms for the various tax credits.

Like the 1040A, additions to the 1040 since 1970 represent an increasingly complex tax law:

Item	Year First Added
Credit for Political Contributions	1972
Work Incentive Program Credit	1972
Presidential Election Campaign Check-Off	1973
IRA Deduction	1975
Tax on Premature Distributions of IRA	1975
Earned Income Credit	1975
Credit for Child Care Expenses	1976
Jobs Credit	1977
Residential Energy Credits	1978
Taxable Portion of Unemployment Compensation	1979
Two-earner deduction	1982

Several of these items required an attached schedule, and most of them have little to do with measuring income. Yet they account for 13 of the 68 lines on the Form 1040 in 1983. The 1984 version of Form 1040 will have a new line for social security income.

The introduction of Form 1040EZ added some complexity in that taxpayers now must choose among three forms instead of between two. Nevertheless, as the short form, 1040A, became longer to incorporate all the changes in the law, it was important to get an extremely short form for the simple-case taxpayers, single individuals with no dependents. Taxpayers eligible for the 1040EZ do not have to contend with the problems of other exemptions, the deduction for two-earner couples, the earned income credit, or the credit for child care. The instructions for Form 1040EZ are simpler inasmuch as only the rules for single individuals must be explained.

Filing Status

For most taxpayers, filing status presents little difficulty. They know whether they are single or married as of the end of the year. Though some married couples may choose to file separately, there generally is not a tax advantage for doing so. The head of household status, however, does present some difficulties. To qualify as a head of household the taxpayer must be unmarried as of the end of the tax year and must provide over half the cost of keeping up a home that was the principal home for certain relatives. Except for a parent, the relative must live in the home the entire year. Also, except for an unmarried child or grandchild, the relative must be the taxpayer's dependent. It is not uncommon for a single individual to claim head of household status even though they do not maintain a home for a relative. The head of household status was added to the law in 1951 to treat single individuals with dependents more favorably than other single individuals, but not as favorably as married couples. Flattening out the marginal rate schedules would reduce the so-called "single penalty," and, therefore, would eliminate the need for a special rate schedule for heads of households.

In addition to the head of household filing status, there is a separate filing status for a qualifying widow or widower with a dependent child. This filing status was added to the law in 1954 and permits certain widows and widowers to use the joint return tax rates for two years even though they are no longer married. Widows and widowers who do not meet the requirements for this special status must file as singles unless they meet the requirements for the head of household status. In 1981, only 112,893 surviving spouse returns were filed, about one-tenth of one percent of all individual returns. The problems associated with providing this special status--primarily that the taxpayer must determine eligibility, and must properly revert to single or head of household status at the end of the transition period--are probably not sufficient to warrant its elimination.

Income Items--Capital Gains

As indicated above, determining the amount of income is not a major hurdle for most taxpayers. Nevertheless, the distinction between capital gains and ordinary income is one of the greatest complicating features of the federal income tax. Much sophisticated tax planning centers around structuring transactions so as to obtain the favorable capital gains tax treatment. It has often been suggested that taxing capital gains as ordinary income--a fundamental change--would greatly simplify income tax law. Clearly if capital gains were taxed at the same rates as ordinary income, the incentive to structure transactions to obtain capital gains treatment would disappear. But the amount of simplification that would result from taxing capital gains as ordinary income can be overstated. Because capital gains would still only be taxed when realized, a limitation would be needed on the amount of capital losses that could offset other income; otherwise, taxpayers would have an incentive to realize their losses and let their gains run. Though taxing capital gains in full would reduce the tension between ordinary income and capital gains, it would increase the tension between realized and unrealized gains. Many would suggest that if capital gains were to be taxed in full, an inflation adjustment would be appropriate. Inflation adjustments would introduce their own complexities.

The sale of a principal residence is an example of capital transaction that is particularly complicated for the average taxpayer, even though little or no tax is due. Under current law, taxpayers who sell a principal residence are not currently subject to tax on any gain realized if they purchase a new residence costing more than the one they sold. Also, taxpayers 55 years of age or over may exclude up to $125,000 of capital gain realized from the sale of a principal residence. Between the rollover and the exclusion, most sales of principal residences are not subject to current taxation. Yet taxpayers are required to complete Form 2119. This form requires the taxpayer to determine the adjusted basis for the residence sold and for the residence acquired. Though taxpayers probably should keep the records necessary to determine the adjusted basis, many taxpayers do not have these records readily available.

Adjustments to Income

Let me comment on three of the adjustments to income--moving expenses, the deduction for a married couple when both spouses work, and the deduction for charitable contributions for non-itemizers.

Since 1964, a taxpayer has been permitted to deduct, via Form 3903, unreimbursed moving expenses incurred in connection with assuming a new job. First, to qualify, a taxpayer's new place of work must be 35 miles or more farther from his old home than was his old job. Second, the taxpayer must accumulate costs from five categories of eligible expenses. Expenses incurred in the physical, one-time move of household goods and family members are deductible without limit. Pre-move travel, meals and lodging incurred on a trip to look for a new residence, temporary living expenses in the new location, and expenses incurred in selling an old residence and purchasing a new one, are, in total, subject to a maximum deduction limit of $3,000. Pre-move travel, meals and lodging for a home-search trip, and temporary living expenses are subject first to a separate cap of $1,500. As a general rule home-selling and home-purchasing expenses exceed the $1,500-$3,000 range. As a result, taxpayers reduce the gain on the sale by the amount of non-deductible selling expenses--though, because of the rollover treatment and one-time exclusion on gain from the sale of a principal residence described earlier, these expenses might never, in fact, produce a tax benefit. Similarly, purchasing costs not fully deducted increase the cost bases of the new home. In 1981, 1.5 million taxpayers took the moving expense deduction. Surely there must be a way to simplify this deduction. At least the dollar limitations should be adjusted to reflect average moving costs today.

As a second illustration, current law, with separate rate schedules for single individuals and married couples, creates a marriage penalty when two individuals with about the same income marry. The two-earner deduction was enacted in 1981 to reduce this penalty. This deduction is limited to 10 percent of the first $30,000 of earned income of the lesser earning spouse. To claim the deduction, taxpayers must complete a separate form, Schedule W. For taxpayers whose earned income comes from wages and salaries computation of the deduction is fairly easy. It is more difficult if the couple has earned income from a business or a farm or if the couple has employee business expenses, claims the IRA deduction, or makes payments to a Keogh plan. The Committee may want to explore whether some reduction in the progressivity of the rate schedule, not necessarily going all the way to a flat rate tax, might permit elimination of the two-earner deduction. Flattening the marginal rates would reduce the marriage penalty without increasing the single penalty that I mentioned earlier.

As a final example, the Economic Recovery Tax Act of 1981 extended a deduction for charitable contributions to non-itemizers. Equal in 1982 to 25 percent of contributions up to $100, or a maximum deduction of $25, the deduction will gradually become unlimited by 1986; it expires after 1986. About 40 percent of all non-itemizers took the deduction in 1983. Greater than three-quarters of those taking the deduction took the maximum of $25, implying that they had given $100 to charity. The computation of the deduction is not particularly complex. And rather than requiring a separate form, it merely adds a line to the 1040, 1040A, and 1040EZ. I mention this adjustment in a discussion of complexity for two reasons. First, it takes a deliberate step against one of the important benefits of having a standard deduction as I discuss below--to prevent the majority of taxpayers from having to "itemize" deductions. Second, this adjustment comes dangerously close to a "tax on honesty," given the low audit rate of short form returns--nearly half of the returns using the deduction were 1040A or 1040EZ. Defenders of this deduction claim that it is needed to provide an appropriate incentive for non-itemizers to give to charity. Congress, nevertheless may want to consider dropping this deduction and raising the ZBA so that non-itemizers as a group do not have a tax increase.

Standard Deduction vs. Itemizing

For taxpayers who use the long form, itemized deductions are a significant source of complexity. A major thrust of the series of tax legislation that began in 1969 and continued through 1978 was to simplify the tax law by increasing the standard deduction (now known as the zero bracket amount) so fewer taxpayers had to contend with itemizing. In 1970, almost 48 percent of taxpayers itemized their personal deductions. In contrast, when the standard deduction was first introduced in

1944, less than 20 percent of taxpayers itemized their deductions. The increases in the standard deduction during the 1970s, decreased the number of returns with itemized deductions from 48 percent in 1970 to 29 percent in 1978. Inasmuch as the zero bracket amount has not been increased since then, the number of itemizers has been increasing, reaching 36 percent of all returns in 1983. The zero bracket amount will be adjusted for changes in inflation beginning in 1985. The table below indicates the number of returns with itemized deductions for selected years.

Itemized Deductions

Most taxpayers can probably write down 90 to 95 percent of their itemized deductions in about five minutes. It does not take long to determine the amount of state and local income taxes withheld or paid with last year's return, property taxes on the home, home mortgage interest, or cash contributions where receipts are available. For other taxpayers, however, computing itemized deductions is the major source of income tax complexity. I want to discuss three particular deductions: state sales taxes, medical expenses, and employee business expenses.

Percent of Individual Returns with Itemized Deductions for Selected Years

	Total Number of Returns Filed (000)	Percent with Itemized Deductions
1983[1]	90,407	36.0%
1982[2]	95,298	35.3
1981	95,396	33.1
1980	93,902	30.8
1979	92,694	28.6
1978	89,772	28.7
1977	86,365	26.4
1976	84,670	31.6
1975	82,229	31.7
1974	83,346	35.5
1973	80,693	34.8
1972	77,573	34.8
1971	74,576	41.1
1970	74,280	47.7
1965	67,596	41.2
1960	61,028	39.5

Source: U.S. Department of Treasury, Internal Revenue Service, Statistics of income Individual Income Tax Returns, various years.

1/ Based on Taxpayers Usage Study data as reported in the SOI Bulletin, Summer 1984. Number of returns represents about 95 percent of 1983 returns to be filed. The percentage may be understated, as returns with itemized deductions may tend to be filed later than other, short form returns and thus may be underrepresented in the sample.

2/ Preliminary data as reported in the SOI Bulletin, Winter 1983-1984.

The sales tax deduction is not complex if taxpayers use the sales tax tables. However, many taxpayers have found it worthwhile to keep track of their actual sales tax paid for the whole year. Adding up all receipts is time consuming. Even taxpayers who use the tables can add to the sales tax table amount the general sales tax paid if they bought a car, motorcycle, motor home, truck, boat, plane, home, or materials to build a new home. A significant simplification could be achieved if the deduction for state sales taxes was repealed. The deduction allowed in the sales tax tables are probably too low and the improvement in equity that is achieved when taxpayers keep track of all sales tax payments is not worthwhile. Simply repealing the state sales tax deduction, however, would bias the choice between income and sales taxes at the state level. One possibility would be to repeal the state sales tax deduction and then make periodic payments from the Treasury to the states equal to what the state sales tax deduction would have cost the Federal government in lost revenue. The payment to the states could be in proportion to state sales tax revenues. States have a better estimate of state sales taxes collected than individuals have of state sales taxes paid.

In 1982, Congress simplified the deduction for medical and dental expenses by eliminating the separate deduction for one-half of medical insurance payments, increasing the floor under the deduction to 5 percent of AGI, specifically limiting deductible "medicines" to prescribed drugs and insulin, and beginning in 1984, eliminating the separate floor for medicines and drugs. Many taxpayers who previously itemized their medical expenses no longer need to be concerned with this deduction; they know their medical expenses are not above the floor. The floor could be raised still further to 10 percent, which is the same limit applied to casualty losses. With the higher floor many more taxpayers would be spared the complexities of this deduction. Taxpayers who nevertheless do itemize medical and dental expenses must contend with some fine lines and a thick body of case law that distinguish between those medical and dental payments that can be deducted and those that cannot. For example, travel your doctor told you to take for a rest or change of pace is not deductible; psychiatric treatment by a qualified professional is. The restriction of deductible medicines to prescribed drugs and insulin eliminates problems associated with determining whether costs of special foods, vitamins or other chemicals should be deductible.

Employee business expenses are clearly a cost of earning income and ought to be deductible under an income tax. Yet these deductions are a source of complexity and generate recordkeeping problems. In 1973, the Administration suggested placing a $200 floor under miscellaneous employee business deductions. This would free most employees from having to keep track of expenses for "shoes, blues, and union dues." The issue is whether the increased simplicity is worth the loss in equity. If a floor is placed under miscellaneous employee business deductions, there will be increased pressure for businesses to reimburse these expenses because they would still be tax deductible at the company level.

Tax Rates

Tax rates schedule are not a major source of complexity. Most taxpayers look up their tax liability from a tax table and since 1981 these tables have not been based on the number of allowable exemptions, making the look-up much easier.

But two comments about tax rates deserve emphasis. First, if tax rates can be lowered as a result of base broadening, income taxes would be a smaller factor in our economic lives as we chose among alternative investments and different uses of our income. Second, the top individual income tax rate should not be too different from the top corporate tax rate. If the individual rate were much lower, there would be undue pressure on the use of personal holding companies. If the corporate rate were much lower, there would be undue pressure for corporations to accumulate earnings and tax authorities would have to enforce the accumulated earnings tax.

Tax Credits

The allowable tax credits for individuals, other than the foreign tax credit, have nothing to do with running an income tax. They are special incentives or tax expenditures. In 1983, Form 1040 had separate lines for:

- Credit for the elderly (attach Schedules R and RP)
- Investment credit (attach Form 3468)
- Partial credit for political contributions
- Credit for child and dependent care expenses (attach Form 2441)
- Jobs credit (attach Form 5884)
- Residential energy credit (attach Form 5695)

Individual taxpayers are permitted to claim three additional credits, but because space is so limited on the Form 1040, they are instructed to list other credits in the margin and include them in the total of all credits on line 48 of Form 1040. Three credits are handled this way:

- Alcohol fuel credit (attach Form 6478)
- Credit for fuel from non-conventional source
- Credit for increasing research activities (attach Form 6765)

Fifteen years ago individual taxpayers only had to contend with two of these credits--the investment tax credit and the credit for the elderly (then called retirement income credit). If these "expenditures" are worth making, they could be made on the spending side of the budget. Pruning tax credits and other tax expenditures that are no longer needed or of a lower priority would be a major step toward simplification.

PROGRESS TOWARD SIMPLIFICATION

Up to this point, I have focused primarily on the increasing complexity of the existing income tax, particularly for individuals. Important efforts have been made to cope with this complexity. As I indicated earlier, in 1982, Form 1040 EZ was introduced, a very simple form which many single individuals may use. In 1977 the Service revamped the Form 1040, making it a linear form that flowed logically from income, to adjustments to income, to tax computation, to credits, to other taxes, and finally, to payments. This was a major improvement which reduced the need to transfer numbers back and forth from related schedules to Form 1040.

In the Tax Reform Act of 1976, Congress simplified the treatment of child care expenses by creating a simple tax credit. Prior to 1976, taxpayers were permitted to take an itemized deduction for such expenses computed on monthly basis. The credit, however, was complicated some in the 1981 legislation which introduced sliding scale percentages for computing the amount of the allowable credit. In addition, the Deficit Reduction Act of 1984 simplified income averaging by reducing the number of years eligible for income averaging and by raising the threshold for eligibility, thus reducing the number of taxpayers who can average.

In recent years, there have been several significant efforts involving the Treasury, the Joint Committee on Taxation and tax practitioners to simplify overly complex areas of the law. These efforts have focused on areas that usually do not affect the "average taxpayer," but rather are important and familiar to tax practitioners. These joint efforts were aimed not at raising revenue or losing revenue. Their goal is simplification.

The first of these efforts involved reform of the Subchapter S rules. This effort goes back to a joint Treasury/American Bar Association project which began in 1966. It came to fruition in 1982, when the Joint Committee staff urged the tax writing committees to move forward in this area.

In 1980, Congress revised the rules for the tax treatment of installments sales, eliminating many of the traps for the unwary. This simplification, which will reduce the complexity of reporting installment sales, has already spawned more than five pages of legislation and eleven regulation projects.

Finally, the Deficit Reduction Act of 1984 contained many of the recommendations that had been jointly worked out for simplifying the tax treatment of domestic relations. Though some practitioners are dissatisfied with the final outcome of this legislation, particularly the six-year rule for alimony, all are agreed that having a general rule that the custodial spouse gets the dependency exemption should reduce the disputes between divorced parents, each wanting to claim the dependency exemption.

The efforts of the Treasury, the Joint Committee staff, and tax practitioners to work toward simplifying unnecessarily complex areas of law could usefully be extended to several other areas. For example, in recent years, Congress has added a number of nondiscrimination rules in the employment benefit area, and each of these nondiscrimination rules is different. Could a general nondiscrimination rule be written? The Code also contains numerous attribution rules for, for example, the related party and Subchapter C Code provisions. Could one attribution rule be written for all situations?

PROPOSALS FOR RESTRUCTURING OUR TAX SYSTEM

In his last State of the Union address, President Reagan called on the Treasury Department to provide recommendations for tax reform by late this year. Treasury is to study a flat rate tax, a tax on consumed income, a national sales tax, and the value added tax. The Deficit Reduction Act of 1984 also instructs the Treasury to study alternatives to the present income tax and to report to the Congress by the end of the year. This report is to include a study of tax shelters.

What implications do the various alternatives for restructuring our tax system have for simplification?

Broad Based, Low-Rate Income Taxes

I believe that the widespread public interest in a flat rate or a broad-based low-rate income tax represents a yearning for a simpler tax. Lower marginal rates which can be achieved by broadening the tax base are a key to simplification inasmuch as lower rates will reduce the incentive value of the exclusions, deductions, and credits that remain.

But not all base broadening would lead to significant simplification. Dropping tax credits, deductions and exclusions that have little to do with measuring net income clearly would simplify the income tax. However, as I indicated earlier, not all of these items involve that much complexity. For example, taxpayers generally can determine the amount of their big-ticket itemized deductions with little difficulty. Though the distinction between capital gains and ordinary income is a major source of complexity, even in a world with full taxation of capital gains, there would still be a need for some limitation on the ability of taxpayers to deducted realized losses against other income. Thus, the distinction in the tax law between capital gain property and ordinary income property would remain. Also, taxing fringe benefits as we learned this past year, involves significant problems of valuation. Congress faced these problems by statutorily exempting from taxation the major fringe benefits that have evolved over the years.

Any fundamental reform of the income tax must treat three issues--capital recovery, the double taxation of dividends, and the impact of inflation. There are no easy answers to these vexing problems, but certainly answers can be devised that limit unnecessary complexity. As I have noted, these three issues would not be a problem if Congress enacted a broad-based expenditure tax, sometimes known as a tax on consumed income.

Consumed Income Tax

Under a tax on consumed income, individuals and families would be taxed on their consumption instead of their income. They would not, however, have to keep track of all of their consumption expenditures. Instead they would be taxed on all cash receipts from employment, business, investment transactions, and borrowing, and would be allowed to deduct cash payments for business and professional costs and for the acquisition of assets and for debt repayment. The difference would be consumption. Progressive tax rates could be applied to this tax base.

Proponents of the tax on consumed income argue that it would be simpler than an income tax. Complex rules for capital recovery or adjustments for inflation, for example, would not be needed. It is not at all clear that the average taxpayer with no business income would find the tax on consumed income simpler than the current income tax. One criterion for a simple tax is that the taxpayer can understand how his or her tax liability is determined. I wonder if the average taxpayer would understand why loan proceeds would add to his or her taxpaying ability. The whole process of measuring saving would be confusing for many taxpayers. An effective tax on consumed income would require complex reporting rules to monitor saving and dissaving. Moreover, a change such as this would require very complex transition rules if large windfall gains or losses are going to be avoided. Finally, many of the gains in simplicity from moving to a tax on consumed income would be lost if the individual states continue to tax income. This is particularly true if states continue to tax corporate income and, absent a federal tax to which the states can conform, the laws of each state diverge. The problems of moving a progressive tax on consumption remind me of the tourist who asked a farmer the way to London. The farmer replied, "If I were going to London, I would not want to start from here."

Value Added Tax or Retail Sales Tax

The tax on consumed income is usually considered a replacement for the individual and corporate income taxes. Transaction-based consumption taxes--the value added tax or the retail sales tax--are generally considered as additions to the current federal tax system. Though either of these taxes are fairly simple compared to an income tax, adding one of them to our current federal tax system can only increase the overall complexity of the tax system. Of the two, the retail sales tax is somewhat simpler in that only retailers are tax collectors. Under the retail sales tax there is some complexity because the seller does not always know if a sale should be taxable or not. Some consumption is doubly taxed and some not taxed at all. This problem is solved under the value added tax by imposing the tax on every transaction and permitting the buyer to take a credit for the tax if he or she shows the purchase was used in a business. But imposing a tax at every level of production and distribution has to be more complex than simply imposing the tax once at the retail level.

CONCLUSION

We are all for a simpler tax. Yet the tax laws seem to become more complex every time Congress meets. Today I have tried to explain how our income tax has become so difficult, by outlining the primary sources of complexity--the need to measure income, frequent changes in the law, complex transition rules, the achievement of minor improvements in equity, over use of the income tax for non-revenue purposes, and the tendency for tax law to be formed through political compromise. I have also offered illustrations of how Congress could simplify the individual income tax by attacking these sources of complexity. Merely discontinuing the practice of annual tax legislation would reduce the need for transition rules and the probability of political compromise, in addition to reducing the errors and inconsistencies that result from frequent law changes. I have also cited specific examples of potentially unnecessary complexity that Congress might reevaluate, including:

- income averaging
- mandatory itemization for dependent children with only passive income
- the array of tax expenditures
- moving expense deduction
- the deduction for two-earner couples

- the deduction for charitable contributions for non-itemizers
- the deduction for state sales taxes
- medical and dental expense deduction
- the deduction for employee business expenses

I do not support wholesale elimination of all exemptions, deductions and credits--the primary sources of complexity for the average taxpayer. Rather, I strongly recommend that Congress reevaluate these adjustments, eliminating those that are no longer necessary or of lower priority, and simplifying those that should remain. This would permit Congress to achieve probably the greatest simplification--to lower marginal tax rates and thus to diminish the role of the tax law in making economic decisions.

APPENDIX

BRIEF HISTORY
OF INDIVIDUAL INCOME TAX FORMS
1040, 1040A, 1040W, and 1040EZ

1960-1982

1960 1040 was a four-page form (front and back of two pages) that contained the main tax form as well as Schedules A through K for detailing sources of income, deductions and credits.

In addition to the regular form 1040, taxpayers could use simplified forms 1040A or 1040W. "Card form" 1040A, 15 lines long, was available for taxpayers with gross W-2 income of less than $10,000, and dividends, interest or other income not subject to withholding not greater than $200.

1040W was a "streamlined 1040" available to taxpayers who could not file 1040A because their income was $10,000 or more, or because they chose to itemize personal deductions. To use 1040W they still had to have interest or other income not subject to withholding of not more than $200 and had to derive the remainder of their income from wages and salaries. It was a full page form with Schedules A and B for exemptions and itemized deductions on the back.

1961 1040W was discontinued.

1962 Regular Form 1040 was reduced to one (front and back) page, with supplementary information taken to separate schedules on separate pages.

1969 Form 1040A was discontinued on the grounds that in using the form taxpayers "denied themselves tax advantages to which they were entitled." It was not reintroduced again until 1972.

The regular 1040 was reduced to one 26-line page, but taxpayers had to go to Schedule T to compute tax if they itemized deductions or took any tax credits.

1970	The tax computation, and summaries of other income, tax credits, and other taxes were returned to the back of 1040.
1972	A new 1040A was introduced, consisting of 2 one-half page pieces of paper with three new features: revenue sharing information, a political contribution credit, and a presidential election campaign check-off. To file this form, a taxpayer again had to receive all income from wages and salaries, could not have dividend/interest income greater than $200, could not itemize deductions and could take no tax credits except that for political contributions.
1973	The $200 limit on interest income was removed from the list of restrictions for filing 1040A.
1974	The limit was reinstituted at $400.
1975	The Earned Income Credit was introduced and added to the list of credits that 1040A filers could take.
1977	An income limit of $20,000 ($40,000 joint) was imposed on 1040A filers.
1981	The income limit was increased: taxpayers could use 1040A as long as AGI less personal exemptions was less than $50,000. The $400 dividend/interest limit was again removed, except that it still applied to taxpayers who had such unearned income and were claimed as dependents on another return; the limit, however, was increased to $1,000.
1982	The 1040EZ was unveiled. It was available to taxpayers who claimed only one personal exemption, had taxable income below $50,000, interest or dividends of less than $400, and claimed no adjustments, deductions or tax credits. Form 1040A was extended to taxpayers who claimed the special two-earner deduction.

Mr. PICKLE. We thank you, Mr. Sunley. We thank each of you gentlemen for your testimony. You are experts, you are learned men in this field, and your testimony and your analysis will be very helpful to us.

It is very excellent testimony and we thank you for it.

I would like to make this observation briefly. It seems to me that this panel in general views with some alarm the pending FAIR or FAST tax proposals. I don't want to unfairly summarize your testimony, but Mr. McDaniel seems to doubt that the FAIR or the FAST tax bill is altogether fair or that it is an incentive for productivity.

And Mr. Bradford recalls the useful "Blueprint for Basic Tax Reform." Mr. Halperin and Mr. Sunley think a lot of the present difficulties stem from the complexity of the current Tax Code. We have too many deductions and too many advantages that can be taken.

Mr. Halperin points out that despite section 61, much income goes untaxed.

And Mr. Sunley now says that a lot of our difficulty comes from the fact that we are allowing too many preferences, we ought to reevaluate these adjustments. My question to you, and particularly Mr. Sunley and Mr. Halperin at this point, pertains to these preferences.

If we were to reexamine and make these adjustments, to make it more fair, do you think the Congress will make those changes?

Do you think it is practical that we actually eliminate these preferences?

We had tax bills in 1981, 1982, 1983, and 1984. We are going to have some kind of tax bill next year. Do you think we are going to make adjustments to areas that we have not touched in the last 5 to 10 years?

Mr. HALPERIN. Mr. Pickle, I suppose you know the answer to that better than I do. I think what Mr. McDaniel pointed out is really the question that needs to be faced. He pointed out these preferences are really not to a large extent tax provisions—some of them are—but to a large extent they are spending provisions.

And you really have to be asking yourself whether you are willing even though rates are cut, in effect, to cut those Federal programs which are run through the tax system. In a sense, people have a kind of a tradeoff which is whether they want to pay the same amount of tax they do today, let's suppose you could actually match it, regardless of how they spend their money, or do they want to continue to have a system which creates incentives for particular types of spending.

If it is put that way, maybe people can be persuaded that the choice is not a bad one. But I think that you have the very serious problem as to whether those who now benefit from particular incentive programs are going to sit still for cuts in those programs.

As Mr. McDaniel also pointed out, just lowering the rates cuts those programs more than half already. It should be viewed just as seriously as repeal would.

Maybe it wouldn't be. And maybe that is a start to trying to get the message across—if you get the rates down, then perhaps the next step could be taken more easily. But I don't think it is going to be easy.

I certainly am not optimistic.

Mr. **Pickle**. Mr. Sunley.

Mr. **Sunley**. In the testimony that the committee heard yesterday, there emerged a general consensus that the deficits are not going to go away unless Congress cut spending or raised taxes. Very few people believe that you can solve the deficit problem simply on the spending side, so taxes are probably going to have to be increased.

I can outline several scenarios. One scenario is you try to get the revenue using existing revenue sources. Part of that would involve looking very closely at the various tax preferences and incentives that are now in the income tax and eliminating or cutting back on some of those that are of lower priority.

And you could say that that would be very hard to do, because all the various special interest groups will come in. The other alternative is basically to adopt a new source of revenue—a value added tax, a retail sales tax, or something like that. A lot of people will tell you that that is very hard to do.

I believe Congress is going to have to do one or the other. I don't want to make a political judgment of which way Congress is going to go. You surely have much better judgment than I in that area.

But I would only point out 2 years ago the general consensus was that Congress would never tax Social Security benefits. The general political consensus—the popular view in Washington that something cannot ever be done—can be proven wrong.

Indeed, Congress did make a decision to tax, in a limited way, Social Security benefits. Given the hard choices of alternative ways of raising revenue, it may turn out cutting back on some of the tax preferences is easier and probably better than adopting a whole new tax for the Federal revenue system.

Mr. **Pickle**. I agree with you. We either have to do one or the other. The choice is up to us. I am afraid that if we were to hold hearings and say we were going to reevaluate the present system or say that we are going to increase the corporate tax we would have to move the hearing over to RFK Stadium.

You know, that is a practical matter and yet the choice will be ours. We probably ought to look at it to see if we can do that. I am afraid we are going to be looking at the changes we ought to be making and then assess some sort of an add-on tax to raise revenue. That is exactly what I am afraid will happen.

Mr. Conable?

Mr. **Conable**. Thank you, Mr. Chairman.

You know, it is very difficult to know how to ask questions of a panel of this sort because you are very knowledgeable and you are also knowledgeable about the political process. Do any of you really think that Congress would pass a simple tax? Could we pass, for instance, a simple value-added tax with a single rate on luxuries and necessities and no credits or exclusions for poor people or that if we did it, we would leave it alone forever?

Mr. **Sunley**. Chairman Ullman, you may recall——

Mr. **Conable**. He said it is so simple.

Mr. **Sunley**. First, he had one rate. The second year it appeared, he had two rates in it. If he were still on the committee, he might have three rates at this point.

Mr. **Conable**. Do any of you believe that if we passed a radical tax simplification that it would stay radically simple for very long? I don't believe we would pass it in the first place, but if we did, would it stay that way? There is always the issue of equity as perceived at a given moment in a complex economy and equity is the enemy of simplicity. I think that while Congress is not going to be responsible about such things, it is going to be responsive. I am sorry I wasn't here, I was over trying to complicate the tax law before the Senate Finance Committee with respect to the permanent extension of the above-the-line charitable contribution, which after all is a matter of grave social policy. The question is, shall you give tax incentives to people who in smaller and smaller proportions as the zero bracket amount goes up, have a tax incentive for giving to charity? That says something in and of itself. That is what I was doing and couldn't hear your testimony.

Did any of you deal with the issue of mode of filing? Do you think there might be some modest issues of equity and complexity involved in whether you let husbands and wives continue to file separately, if you change the tax system dramatically? What about minor children living in the family? We talk about capital formation as though that were the only issue in taxes. Just stop to think of what a complicated thing that is. Just how do you handle the mode of filing in the family? If you don't have a totally flat tax, you still have a marital penalty and nobody seems to think we are going to have a totally flat tax. Would somebody like to address that issue?

Mr. **Sunley**. In a portion of my prepared testimony which I did not summarize, I did talk about the alternative filing status. This has been an area involving some very hard tradeoffs between marriage and single penalties——

Mr. **Conable**. The minute we try to reduce the marriage penalty, the singles say they are entitled to equity also.

Mr. **Sunley**. To the extent that we can flatten out the rates somewhat you could drop the head of household status. Most people know whether they are married or single. The problem is with the head of household status. Some single individuals think that because they are living in separate households, they ought to qualify for the head of household status. I suggest that we ought to try to flatten the rates enough so that maybe the need for a head of household status would end.

I have never favored going to separate returns for each individual, which is one way to solve the marriage penalty. I think that would add complexity to the law. As long as we think of the family as a single unit, there will be tension between one or two earner married couples and single individuals. To some extent you can mitigate that tension by reducing the rate of increase in marginal tax rates through the middle income range.

Mr. **Conable**. Thank you, Mr. Chairman.

Mr. **Pickle**. Mr. Anthony?

Mr. **Anthony**. A quick question of each of the members of the panel and then a followup question for Mr. Bradford. If you had your choice to replace the existing income tax situation, would you go to a consumption-based tax?

Mr. Halperin, I believe your testimony said you would not.

Mr. **HALPERIN.** I would stick to the income tax and try to have as broad a base as possible. I don't think we can ever get a simple tax. That shouldn't stop us from trying for a simpler tax. I think it is only the direction that we move in that is significant.

Mr. **MCDANIEL.** I would reach that same conclusion, Mr. Anthony.

Mr. **SUNLEY.** I have also been in the income camp and would prefer to keep a broad-based income tax.

Mr. **ANTHONY.** Mr. Bradford, I guess what I would like you to address and this is a question I was hit on as I was speaking to a group of business people who came to Washington to find out what is going to happen in 1985, are we going to cut spending and they are not going to have their taxes raised or a combination of the two. I said there would probably be some taxes raised in 1985. Dave Stockman told me that we couldn't grow our way out of it and Rudy Penner said we couldn't grow our way out of it. You seem to think we are not going to grow our way out of it so the reasonable approach is we are going to have to do something on the tax side. Why would you go to a consumption-base tax and could you address any transitory problems that you would foresee if we did that?

Mr. **BRADFORD.** The first point I would make about the consumption base is there are many different ways you could go to a consumption-type tax and many would look like an income tax and certainly be as progressive. I would go in that direction because I believe that is a fair basis for assessing taxes, making differences among people. I think that is a good principle of assessing a tax. Second, there is no doubt about the simplicity advantages and I think the testimony at this table which has appeared to say the opposite is just wrong and I would be glad to engage in debate about that. There is just an enormous simplicity advantage to going in that direction.

A third point is that because it is possible to have a simple set of accounting rules to implement this tax, you will eliminate a lot of mischievous waste in our economy, the phenomenon of the tax shelter promotion being just a typical example of it. So these are the reasons I would go in that direction and I think that is neither in opposition to nor in itself helpful on the matter of raising revenue.

Mr. **ANTHONY.** Could you quickly address the problem of transition?

Mr. **BRADFORD.** There are really two kinds of problems that you get. One is a difficulty that in some versions of a consumption-type tax. Suppose we put on a VAT tax; people would object that this is unfair to those who have accumulated their savings and are now going to have to pay another tax when they spend it. That is the type I problem of transition. The type II problem is the opposite. Because a consumption-type tax does not tax the return to savings, wouldn't tax interest, for example, you get the possibility that people who have made large accumulations will have it too good in the future.

The well-to-do person has a large accumulation and is going to live off it and not pay any taxes in the future. That is another problem. One has to find a way to split that difference to achieve consumption-type taxes in the end. We would have to go into a lot of detail of a particular plan to get further than those principles.

Mr. **McDaniel**. I think it might be worth noting that, in thinking about a consumption tax as a base, one also has to think about what the rate structure would look like under a consumption tax. Because the base is so much narrower than in income tax, the rates would presumably have to be higher at least if established on a tax exclusive basis. Suppose you have an individual today in the 50-percent tax bracket who buys a $10,000 car. To make that purchase requires $20,000 of income because tax is imposed at a 50-percent rate. In a consumption tax, a 100 percent tax exclusive rate would be required on the car transaction in order to get the same revenue. Perhaps Professor Bradford has developed a rate structure that we could utilize. While it is true that in a sense one could analyze the situation today as 100 percent tax on that consumption transaction, people don't think of it that way. And it becomes difficult to know what rate of tax is applicable to a particular consumer transaction.

Mr. **Bradford**. With all due respect to my colleague, that is nonsense. The written testimony that I presented describes the type of tax—it is a consumption-type tax reported in the "Blueprints for Basic Tax Reform." A diligent effort was made to estimate the rates required to roughly duplicate the distribution of tax burdens in 1976 and the top rate—expressed on a tax inclusive basis—was 40 percent. The difference between the consumption-type tax and the income tax is not that large. I cite also in the testimony the Hall-Rabushka plan which is a consumption-type tax which you will hear about in the next panel. They have a very, very radically broadened base and are able to achieve their tax results——

Mr. **Pickle**. The House has a quorum and the time is short. I will call for approximately a 5-minute recess. Congressman Heftel is on his way back from the floor and the Chair will ask him to preside when he returns.

If this panel will retain its position, we will resume in just a few minutes.

[Brief recess.]

Mr. **Heftel** [presiding]. If we can reconvene, thank you.

Professor Bradford, assuming that we could do the impossible that was being talked about when we broke up, previously and people were convinced somehow, both your colleagues and mine, that be it a progressive consumption tax or be it a cash flow income tax that it were both fair and feasible, how would you then structure your corporate tax? How would you integrate it with, let's say, the progressive consumption or so-called cash flow concept that is now being used to distinguish between the sales tax, the VAT and then the so-called consumption tax, which simply is nothing like the VAT or the sales tax?

Mr. **Bradford**. There really again, there are very many possibilities which would be consistent with consumption-type taxes at the individual level. Again, in the next session, you will hear from Messrs. Hall and Rabushka about a plan which has a particular method of taxing all businesses, including corporate business. However, a less radical sort of transformation could be made which would introduce at the corporate level a cash flow-type tax in addition to the tax at the individual level. The steps that would be required would not be very radical because in many ways we have a lot of the features in the present law.

For example, instead of allowing corporations to write off their investments on the basis of ACRS, you would allow them to expense their capital outlays. You would do the same thing for inventories. There would be a series of such steps you could take to convert the existing corporate tax into a cash flow tax at the corporate level. This would lead to a very nicely integrated system even though you don't do anything to allocate directly to individual shareholders the corporate tax.

Mr. **Heftel**. Would you then eliminate the tax on dividends when received by the stock owner?

Mr. **Bradford**. That would be the usual treatment under a consumption-type tax. You would have no tax as such on dividends nor dividends or interest or capital gains, although you could have a tax at the corporate level that has some of the same functions.

Mr. **Heftel**. I have no other questions and I would defer to my colleagues—Mr. Pease, I am delighted to have you with us. Mr. Pease, the floor is yours.

Mr. **Pease**. I want to state for the record, Mr. Chairman, that I have been with you all along. Thank you, Mr. Chairman.

I would like to ask our panelists about the progressivity, of a theoretical consumption-based tax in relation to the FAST and FAIR proposals that we have been talking about today. If one were to divide the taxpayers of America into quintiles, according to income, has anybody looked at changes in the distribution of the tax burden among quintiles or different classifications of taxpayers, which would occur under FAST or FAIR or under a politically viable consumption-based tax proposal?

Mr. **Bradford**. I could take a hack at that question, Mr. Pease. The written testimony that I submitted includes statements that were prepared at the Treasury Department in this blueprint study in 1975–76 that tried to estimate the effective rate of tax of individuals in different income brackets at that time. We then tried to figure out roughly what would happen if we implemented various sorts of flat rates on that base. Essentially, our conclusion was that the feasible flat rate taxes would almost all have the property that they would relieve the top bracket taxpayers of some tax, put low bracket taxpayers out of the system because of higher exemptions, and subject the middle bracket taxpayers to more tax.

And the testimony also presents, right after page 6, an estimated rate structure that would be required under either a comprehensive income or consumption-type tax to duplicate the tax progressivity that existed at that time. Since then, there has been some flattening of the rate and the structure of brackets is somewhat different, but they would be something like that if we used the same basis for making the estimates.

Last, I would say that we have to take all of these estimates with some grain of salt in that these numbers are built up from tax returns themselves and one thing we don't know—these are based on the Treasury's tax model—we don't have good information on the extent to which taxes are being evaded so we are not sure who those people are who are now not paying their tax, who are taking improper deductions for their company car and so forth. That sort of information, which probably has a lot to do with the effective progressivity of our system, is not well dealt with.

Mr. McDaniel. The FAIR tax proposal has, as its broad objective, retention of the same distribution as under existing law.

Mr. Bradford. The FAIR tax does not deal with the corporate tax.

Mr. McDaniel. There is a separate corporate component to the FAIR tax.

Mr. Bradford. These numbers that I refer to in "Blueprints" concern replacements for both corporate individual taxes.

Mr. Halperin. It seems to me that we have talked about the net tax burden today, but if you go back to Mr. McDaniel's testimony, he pointed out that you could look at the present system as an exchange of checks. Yet none of these proposals are trying to match. They gross tax so they assume that the tax burden paid by a lot of people is the net amount of the check they now send. If it really is a bigger check and they get a subsidy and we are repealing the subsidy, we ought to look at the gross tax burden as the amount that we are supposed to be matching. The proposals allocate the revenue from spending cuts to those who nominally receive the subsidies.

So you could say all these proposals change progressivity, reduce it significantly.

Mr. Conable. On that point, there is a difference between revenue neutrality that and budget neutrality, is there not? For instance, if you are going to eliminate a lot of preferences in the process of radical tax simplification, aren't you going to have to take up the slack in the budget for some of the social purposes achieved through the tax law if you no longer are dealing with that perceived problem through the tax law?

Mr. Halperin. Certainly a lot of the proposals before you suggest that you are not going to do that at all. I agree that that is a pretty strong assumption.

Mr. Pease. Mr. Sunley, did you wish to comment?

Mr. Sunley. I think it is important to keep separate the issue of what ought to be the tax base and how that tax burden should be distributed across income classes. Both the Bradley-Gephardt and the Kemp-Kasten proposals were designed to raise roughly the same amount of revenue and to distribute the tax burden roughly the same way across income classes. I am not certain that both proposals indeed achieved that objective, but that is the objective of their sponsors. Thinking just about tax issues, keeping separate the issue of what ought to be the tax base from the question of how much revenue should we raise as well as from the question of how the burden of taxes should be shared among low-income families and individuals and higher income families and individuals, is an important distinction for getting a rationale tax policy.

But as I say in direct response to your question, the two proposals that you mentioned are both designed to be revenue neutral as well as distributionally neutral, compared to current law which I think was current law before your efforts this year.

Mr. **Pease**. Well, I know that the goal of the sponsors of FAIR and FAST was as you indicated. I hope someone will do some research to let us know whether the objective is likely to be achieved or not.

My gut feeling on the consumption-based tax is that it would be very difficult to institute a consumption-based tax which did maintain anything like the same degree of progressivity as the current income tax system. My assumption is that taxpayers currently earning say less than $20,000 or $25,000, which includes a lot of the taxpayers in this country, would find it difficult to save very much money on that kind of income. They really have to spend much of their income for housing and food and medical supplies and so on, whereas higher income groups, $60,000, $80,000, $100,000, obviously have some discretionary income.

Am I wrong, or is there some way that a consumption-based tax can get around what appears to me an inherent difficulty in establishing progressivity?

Mr. **Bradford**. I think you are not wrong, although I am not sure that the conclusion you draw is the right one. The family or person that is now making $20,000 and spending it all is effectively on a consumption tax—apart from incentive effects, because that person confronts the penalty from saving if there is a decision to save and the penalty on saving is being felt by that family as well as anyone else—but the tax burden is exactly that which would apply under a consumption tax.

The wealthy you would have to tax at higher rates under a consumption tax to achieve the same effect. The data I referred to show that. The top rate is a little higher on the estimated broad-based consumption tax and the bracket cuts in a little earlier.

Mr. **Halperin**. Isn't it that the place you cut it off is very important. If you had a bracket starting at $100,000 instead of $50,000, then the difference in rate would have to be significantly greater than at $50,000.

Mr. **Bradford**. The point is that the difference is not night and day between the systems. I think it would be a mistake to make judgments. If you are thinking about comparing with the present system what it would look like if we moved to any of these purified consumption-type bases, I don't think it would be correct to say that making the rate structure look sensible and reasonable to people would be a problem. I don't think it would. I think that is incorrect.

Mr. **Heftel**. Would the gentleman yield?

Mr. **Pease**. Certainly.

Mr. **Heftel**. If you had a cash flow income tax and a family of four with an income of $14,000 as exempted, they would be in the same identical position as they would with the present system with the same $14,000 exclusion. To the extent there was a tax from $14,000 to $20,000 or whatever that amount may be, they probably would be almost identical but there is no inherent unfairness because you use the consumption tax concept if it is progressive than the present system as far as the idea that people with lower incomes can't save, to the extent that they aspire to higher incomes, they may become beneficiaries of the fact that they can in fact benefit from savings as their incomes increase, and I am not sure that there is any discrimination at all other than an image that seems to be more of the problem.

It seems to be more of an image that people are dealing with than a real problem.

Mr. **Pease**. Well, if there is a real problem, it ought to show up in any comparison of the distributional effects a change to a consumption-based tax would have.

Mr. Bradford, you refer in your testimony to a penalty for saving for high income people under the present tax system. I guess I would view that as a penalty for having to spend all of one's money for basic necessities of life if you go to a consumption-based tax. The question is there is a penalty one way or another and it depends on how you look at it. It seems to me if you were going to go to a consumption-based tax, you would have to have a substantial difference in the tax rates at higher levels in order to offset the fact that 100 percent of the income of the $15,000 a year person is going to be taxed in contrast to 80 percent or 75 percent of the income of a person who is able to save money. In order to maintain the progressivity that is in our current tax system, you would have to have another level of higher rates for higher income people. I don't think that I have seen that kind of substantial difference in rates for higher income people in any of the proposals for a consumption-based tax.

For that reason, it is hard for me to see why there would not be an adverse effect on the distribution of the tax burden among income classes.

Mr. **Bradford**. Mr. Pease, I have various reactions. First, the statement that the high income taxpayers face a disincentive to save, I hope I made that conditional. They would if we had a real income tax because that includes the tax on earnings from using your effort to earn a living and the yield from your saving and of course it benefits you for dissaving or for borrowing. That is the nature of an income tax. The higher the rate, the more the incentive is in place.

That isn't the same that they now face a disincentive to save because it isn't clear how much we tax people on their savings. I suggest if you do the thought experiment, imagine from tomorrow we said we no longer tax dividends, capital gains or interest and we don't allow the deduction, ask whether you think your well-to-do constituents' taxes would go up or down. My guess is for many their taxes would go up. If we are thinking about duplicating the present degree of progressivity, it isn't clear what you would want to do. That might be a progressive step to take.

I come back to the Blueprints study—I don't think the data are the absolute truth, but they did represent an earnest effort to match the existing distribution of tax burdens as we saw it at the Treasury at that time on the basis of those data. The rates are there and they aren't that different.

So I just think it is incorrect to think they would have to be very different to achieve the sort of degree of progressivity that we now have even using that basis for decising what we now have.

Mr. **Pease**. Finally, Mr. Chairman, I, like Mr. Conable, am a little skeptical, from a political point of view, that Congress is going to enact any sweeping reform and simplification of the income tax system which would eliminate a lot of the current tax expenditures. I can't see that happening politically. I was just wondering what the panel might think of the possibility of raising a significant amount of revenue through going after tax expenditures by eliminating some, and for others that could not be eliminated, perhaps imposing a percentage reduction saying whatever the deduction or preference you have taken in the past, you can take 80 or 75 percent of it. This approach would not eliminate the benefit, but some revenue would be picked up. Or, a ceiling of some kind could be placed on the amount of deductions and exemption, an individual can take. Also, it is important to try to tighten up on tax compliance.

Does it seem at all feasible to any of you that significant amounts of revenue could be raised through an approach like that?

Mr. **McDaniel**. I think the answer is yes. Your approach in part is the one that I have endorsed as the correct one. I think one has to keep in mind, of course, in the process of implementing your approach, you are moving counter to tax simplification goals because phaseouts and percentage reductions inevitably create complexity. As Mr. Sunley pointed out, the sheer presence of those tax expenditure provisions in the system complicate it and, if you start adjusting them further, you will make matters still more complicated. That is something you have to keep in mind.

Mr. **Conable**. You still have to have additional arithmetic computation to get there. That is one of the problems with the minimum tax. You say we still want you to use the preferences but if you do well, we will punish you, put a super structure on top in order to get people who use the incentives that you encourage them to use.

Mr. **Bradford**. I very much endorse that view. I think it has been a big mistake to go at this problem through patches of that kind. It is more important to figure out what is the basis on which you want to assess taxes and get there. The technique of putting a patch on a patch there has gotten us where we are. On the point about compliance, I have no doubt that we could raise a lot of revenue through increased compliance. The Congress went through this—we went through the effort of trying to get withholding on dividends and interest this year as a very simple compliance measure and we see what happened and it has always amazed me how little we spend on auditing.

Mr. **Conable**. We like compliance, but we don't like the people who enforce it.

Mr. **Pease**. Do any other panel members have any comments at all on my idea for expenditure limitations of some kind?

Mr. **Sunley**. Let's take the itemized deductions. One alternative would be to repeal some of them, and that is obviously the simplest approach. But what you are saying is that if we can't do that, what are some other approaches? People have talked about putting a floor under itemized deductions; that is, you can only take itemized deductions in excess of 5 percent adjusted gross income. That would raise quite a bit of revenue. At the margin, your itemized deductions are still worth as much.

You can say you have home mortgage interest only up to a mortgage of $100,000, beyond that, you are on your own. We are no longer going to be subsidizing homeownership. Another approach is to say we won't use a floor or ceiling, just eliminate 10 or 20 percent of all itemized deductions so that when you give $1 to charity, instead of deducting $1 you deduct 90 cents. That cuts into the incentive effect of the deduction, raises revenue, but makes it more complicated than simply repealing itemized deductions.

That is an approach not all that different from what you have done in the last couple of years, with respect to business taxes. You cut back 15 percent of them, and in the last bill you increased that to 20 percent. In one part of the code you provide certain incentives and in another part you say you only get 80 percent of what you otherwise would have gotten. It is complicated, but it can be done.

Mr. **Halperin**. It seems to me if you view it as cutbacks in spending programs, you would have less trouble theoretically dealing with it. If a proposal like yours were made in the appropriations committee, nobody would blink.

It is only when you make it here that it looks a little difficult.

Mr. **Pease**. Mr. Chairman, I would like to conclude with a comment. A lot of the folks at this hearing today say it is tax simplification. I can understand the desirability of tax simplification.

But an imperative given to us yesterday by our witnesses was to raise revenue and do it in a hurry, in 1985, before the window of opportunity is gone.

It seems to me that aside from the political difficulties in tax simplification, no matter how long we take, at best we are talking about a year—if we are lucky—to get any really simplified plan in place. My judgment is we don't have a year to do it.

So the reason I am attracted to something in an approach like this is it could be grafted onto the present system rather quickly in 1985. Thank you, Mr. Chairman.

Mr. **Heftel**. Thank you.

Mr. Conable.

Mr. **Conable**. Mr. Chairman, I have one more question. It may be in your testimony, Mr. Sunley.

This is a very basic question. Isn't our current tax system much more progressive than it is perceived to be. I have always heard the rule of thumb that the top 10 percent paid 50 percent of the income tax, the next 40 percent paid 40 percent, and the bottom 50 percent paid 10 percent. That is the profile of a significantly progressive system. The basic perception of the American people is that rich people don't pay any taxes. What they read about in the papers is the exceptional taxpayer who uses sheltering to an excessive degree.

It seems to me that I recall also the figures that roughly 80 percent of the individual income tax raised comes from withholding from wages and salaries, and of course sheltering is available in significant degree only to people who have been able to accumulate sufficient savings so they can invest them in sheltering schemes of one sort or another. It is difficult to shelter without that. And thus it seems to me entirely probable that despite the prevalence of sheltering as a cocktail party subject for the wealthy to describe, in fact we still have a rather progressive system.

Now, am I out of date on that, or is that generally the case? I realize that I was giving you only rule of thumb when I said the top 10 percent paid 50 percent and it varies from year to year depending on economic circumstances. But is that generally the case?

Mr. **Sunley**. That is generally true. The income tax is a progressive tax. The tax burden as a share of income does rise with income. It is probably a significantly more progressive tax than the man in the street believes.

There have been a number of surveys of taxpayers that would suggest that the average taxpayer believes that someone making twice as much income probably pays a smaller share of their income in taxes than he or she does.

This just is not true, on average. Obviously there are those exceptional cases where people have zeroed out of their tax liabilities by using tax shelters or other devices. And this perception problem is a serious one. Because our——

Mr. **Conable**. Perceptions are what politicians deal in. Reality is what legislators have to deal in. There seems to be a significant gap.

The problem is this group is made up more of legislators than politicians. But the people who are not members of this committee tend in some cases at least with respect to their discussion of taxes to be more politicians than legislators. And I wanted to be sure that my basic perception of the relationship between reality and broad perception was not totally inaccurate.

And, apparently, it is not; is that correct?

Mr. **Sunley**. By no means.

Mr. **Conable**. Thank you.

Mr. **Heftel**. I might carry that forward just for an additional moment with you gentlemen. We are speaking now that the public is being told by some magical form of fairness we will have those who earn great sums of money paying their fair share, and the rest of us will have to pay less.

I am wondering, what is going to happen if we were to be successful in so-called reform and some 50 or 60 percent of middle America with incomes, using just a sample, of $30,000 a year find that we have now charged them for fringe benefits, and that their taxable income has gone from $30,000 to $42,000, and that even if the percentage that they pay has gone down, they still seem to be paying the same or more, and that there is no real distortion, as Mr. Conable has pointed out, between what the so-called wealthy would pay and what the rest of us pay.

And that under the name of reform they have been deceived because fringe benefits having been added to the taxable income, they seem to think that they have lost. And then what happens to the credibility of what we have done, because nobody seems to be aware that one of the plans afoot will charge them for all of their fringe benefits.

Mr. **Bradford**. I think that you do much better if one faces up to the fact candidly what they have experienced is a reduction in their Federal subsidies, and stated in just that fashion. People, I understand, do not like to think of themselves as recipients of Federal subsidies, but that is certainly the case.

And that is what is going to happen as you approach these kinds of provisions.

Mr. **Heftel**. Do you think the politicians that Mr. Conable referred to are really going to try to explain to the people that we are now going to charge you for something that you have been getting, which is an expenditure at the Federal level, and, therefore, you are going to pay your fair share on those fringe benefits?

You think that that will be a way to sell any so-called reform tax legislation?

Mr. **Halperin**. I don't think you can sell any of these programs on the grounds they are either going to be simpler to the rank and file, ordinary individuals, or likely to produce less tax burden for them given the revenue needs of the country.

So I think that promoting it in that way is undoubtedly going to lead you into difficulty.

Mr. **Heftel**. Don't you think what is occurring now across the country, based upon at least what I have seen, is there is a perception growing from the public being told that there is a solution in reform which doesn't really exist in fact, and that we are going to have a greatly disappointed public if we proceed to bring about that reform under the umbrella that is now being exposed to the public.

Mr. **Halperin**. If it means the public thinks they are going to pay significantly less or have a significantly simpler tax return, I think the answer to that has to be no, that is not going to happen. The benefits of this, if there are any, are going to be along the lines of more neutrality for the investor and business people and greater simplification perhaps in the kinds of rules they have to face.

But if we are talking about the wage earner and the rank and file taxpayer, I don't see either simplicity or tax cuts happening.

Mr. **Heftel**. Mr. McDaniel.

Mr. **McDaniel**. I think I agree with that. As my testimony indicates, tax simplification is simply not a response to the question: "Am I going to have my home mortgage interest deduction taken away?"

Mr. **Heftel**. Mr. Bradford.

Mr. **Bradford**. I was recently reading the book that Senator Bradley wrote to promote his own proposal. I was very impressed with the political message that seemed to me to get across—that he was telling people that, sure, we are going to raise taxes for some and cut some for others, but we are going to end up with a system that makes a lot more sense.

It seems to me that that might well sell—though, I am not either a politician or legislator.

Mr. **Heftel**. Unfortunately, it is not the book that people make their judgment on. It is some political statements made in political environments that sound much different.

Mr. **Bradford**. I should think if one developed a sufficient motion in that direction that the press began to say there really is something that can be done here, and these are the sorts of gains that we might obtain, that people would be prepared to sit still—in fact, even be satisfied with the resulting change in the system.

Mr. HEFTEL. Mr. Sunley.

Mr. SUNLEY. I believe it is important to tell the American people that we are going to have to raise taxes. I think the American people are probably prepared to accept somewhat higher taxes if something could be done about the deficit.

Maybe you need to adopt a proposal to earmark the increased taxes for the deficit in some way—I am not sure that can be done realistically. But I think it might politically be important to do so.

I do think you just have to tell people there is no way we are going to reduce the deficit without doing part of the work on the tax side, and then, I think people would accept the higher taxes.

Mr. HEFTEL. I thank all of you gentlemen. I think the message above all else is we are going to have to be pretty honest with the American public if we are to do anything and have it work—and if there is any perception inherent in it, it is going to backfire.

In our next panel Senator DeConcini is going to introduce two members of the panel who are participants with him in his tax proposal. The panel will consist of Harvey Galper, Henry Aaron, Robert Hall, Alvin Rabushka, and Richard Goode.

STATEMENT OF HON. DENNIS DeCONCINI, A U.S. SENATOR FROM THE STATE OF ARIZONA

Senator DECONCINI. Mr. Chairman, I have worked with the gentlemen I am going to introduce at great length and I am very excited that you would have these hearings on alternative tax proposals.

I want to thank you for scheduling them, and I ask that you pass that on to your fellow members. I am honored to have an opportunity to address this esteemed committee.

Mr. Chairman, across this country of ours Americans are becoming increasingly disillusioned with a system of taxation which they perceive as unnecessarily complex, inequitable, and really out of control.

Judging by my mail, and by my conversations with constituents and colleagues, I am firmly convinced that a fundamental change in our tax law must be assigned the highest priority which this committee indeed is doing and must become top on the national agenda.

It is for these reasons that today's hearings on fundamental tax restructuring are so timely and so vitally important. I have had the distinct pleasure of working closely with the architects of what I consider the simplest, most comprehensive and fairest alternative tax plan.

My particular bill in the Senate, S. 557, embodies the principle of the Hall-Rabushka flat tax scheme. Dr. Robert Hall and Alvin Rabushka of Stanford University, Hoover Institute, have designed a completely new tax system to replace the personal and corporate income tax system which are so contemptuously regarded by our citizens today.

Under the simple flat tax, all income would be taxed once and only once at a uniform low rate of 19 percent. The system is not an academic aberration.

Drs. Hall and Rabushka have worked out the details of the simple tax, even going so far as to design new one-page tax forms. The proposal has withstood the scrutiny of leading experts on taxation and has been endorsed enthusiastically by a great many of them.

In addition to creating a fair tax system, I believe that with passage of this bill, we will also see many favorable indirect benefits, such as increased productivity, more faith in our system of taxation, and a gradual narrowing of our Federal budget deficit.

It is now my pleasure to introduce Drs. Hall and Rabushka to the Ways and Means Committee. They have appeared before the House Ways and Means Committee and Senate Finance Committee in the past and their testimony has always been helpful.

As history has demonstrated time and time again, few forces are as capable of fomenting popular discontent as an unfair system of taxation. This country was born of a popular tax revolt.

And I hope that we can act to enact a revolutionary tax reform rather than ignore the widespread dissatisfaction of the people of this country.

Justice is our heritage, Mr. Chairman, equality our legacy. We now have the opportunity to reaffirm these precious principles by enactment of a fair, flat tax bill. We are facing a taxation crisis in this country, and sooner or later we must take action.

I urge this committee to continue its good work and hope it will give careful consideration to not only the testimony this morning, but the book and other treatises on tax that Hall and Rabushka have published.

I urge the chairman to ask some of the astute questions that he asked the other people in the previous panel, because I think you will be very interested in the answers from Dr. Hall and Dr. Rabushka, as well as the other panelists.

Thank you, Mr. Chairman, for your time.

Mr. **Heftel**. Thank you very much, Senator.

I suppose it would now be appropriate for either Mr. Hall or Mr. Rabushka to present your testimony.

STATEMENT OF ALVIN RABUSHKA, SENIOR FELLOW, THE HOOVER INSTITUTION; AND ROBERT E. HALL, SENIOR FELLOW, THE HOOVER INSTITUTION, AND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

Mr. **Rabushka**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. May I interrupt you just for a second? Some of the people who will be affected by what we might do here have come to visit us today. I would like to welcome the elementary school of Wood Acres in Bethesda, MD. There are apparently 50 or more young people here.

I think it is notable for us to have you present. It is an opportunity to let you know that what we are talking about today may affect your future more than ours. We are delighted to have you here.

Mr. Rabushka, you may proceed.

Mr. **Rabushka**. Thank you, Mr. Chairman.

I would like to express my appreciation to Senator DeConcini for his introduction. We found it a privilege and opportunity to work with him in trying to promote the idea of a fair and effective tax reform.

We have submitted rather lengthy testimony. We will try to summarize the highlights. What I want to do is focus on the main features of the plan and Professor Hall is going to address some of the aspects of the plan, in particular the question of equity or equitability, the distribution of the tax burden, the incentives that our plan will provide, and also the implications for the broader question of deficits which concerns this committee.

Let me begin by noting that almost all panelists who appear here agree on the need for comprehensive tax reform. Maybe the better word is overhaul—the need has never been greater and the main point of that is perfectly clear—complexity.

A second area of concern is costs. There are two kinds of costs: one in lost economic efficiency; the other is simply inefficient tax administration and taxpayer compliance costs. A third area is the burgeoning tax shelter business and rising evasion, or for want of a better word, cheating.

A fourth concern is the question of deficits. We just don't seem to raise enough revenue out of the current system.

And a fifth concern, equity. And I think most people would agree our present tax system is unfair.

What I would like to say is the plan we have devised, and we will call it the Hall-Rabushka plan hereafter, promises to deal with all five of these points.

The first is it promises postcard-sized simplicity for both individuals and businesses. In the testimony we reproduce these cards. But I have brought some along. And literally the entirely corporate and individual tax codes can be returned on two postcards.

Members of the prior panel doubted this could be done. I think we have done it, and we would like to explore with you how that can be done.

The second concern is that we propose to sharply enhance incentives for a more efficient economy, and, at the same time, create a much more expeditious tax administration consistent with our principle of voluntary compliance.

Third, we would like to eliminate tax avoidance in the sense of eliminating the deductions that clutter the current code, and we would sharply lower the attractiveness of evasion because, at a top uniform rate of 19 percent, it is just not worth risking cheating to get 19 cents, as it is today at 50 cents.

We think we show in our testimony that by adopting the plan we propose, it would be possible to ultimately reduce and eliminate the deficit.

Finally, and I think this will be a very important part of our joint testimony, we propose to show that our tax plan is actually fairer for working Americans who derive their incomes from wages and salaries.

Let me turn then to the main features of the plan we propose.

The first is that we propose to impose a low tax rate on a broad base of income.

Second, our plan embodies a good degree of progressivity. We exempt the poor altogether. A family of four, for example, would not begin to pay income taxes until its income approached approximately $13,000.

That would exempt all those below the poverty level and some of the near poor from the effects of the income tax. Because of this large personal allowance, the system becomes progressive because the share of your income paid in taxes rises as your income rises.

A third feature of our plan is that it embodies the consumption principle. You are taxed only on what you take out of the economy, which seems to be a sensible way to design a tax system.

The fourth is that our tax system is simple to understand and simple to comply with. I think you could reasonably sit down at a quarter to 12 on April 15 and begin to fill out your form and get it done in time to make it to the post office for a midnight cancellation.

A fifth principle is that we propose to tax all income only once, no more than once, and at the source where it is earned. This would therefore eliminate the problem of double taxation that so many have talked about.

We, in short, do integrate the present corporate and individual income taxes, which is possible only at a uniform tax rate.

Finally, the key to our plan is taxing at a uniform rate. And it is very important to have a uniform rate in order to minimize all the maneuvers we now have for multiple rates; people constantly maneuver to adjust their income, to shift it from low bracket to low bracket recipients.

Now, let me look at the actual mechanics of our plan to see how it works. The first point to make, and this is a very important point, is that it is an integrated flat tax which applies to businesses and individuals, though we use two forms for reporting.

It is important to keep in mind that our business tax is not, in fact, an exact replacement for the current corporate tax, and our wage or salary tax is not an exact replacement for the current individual tax.

There is no difference in our system between incorporated and unincorporated businesses for tax purposes. Rather we use two forms in order to give individual wage earners a large degree of progressivity in their income.

Let me turn first to the wage or salary component of our tax, and you will find that tax form reproduced on page 8 of our testimony. By looking at it, I think you can see how easy it would be for about 80 percent of all Americans who derive their income from wages and salaries to file this particular return.

He would simply report on the form wages, salaries, and income received from pensions, and could compute very quickly the appropriate allowance depending upon marital status and the number of dependents.

Having subtracted the personal allowance from income, he would multiply the difference by 19 percent and that is all there is to it, insofar as the individual salary or wage tax is concerned.

With respect to business income, keep in mind this is not the same as corporate income, but it is the more broader notion of business income which today is filed partly on individual returns, partly on corporate returns. It would, therefore, include income from interest, from dividends, from rents, from royalties, from farming and the like.

Our business tax is, in effect, a giant comprehensive withholding tax on all kinds of income with the exception of the wages, salaries, and pensions which are reported by individual wage earners.

This particular comprehensive withholding at source would end all of the evasion that takes place on interest and dividends today, which constitutes a substantial portion of tax base erosion.

Businesses would not be allowed a deduction for interest, dividends, or other payments to people or for fringes. Therefore, any time an individual received payment from the business it would have already been taxed. There would, therefore, be no need to tax it a second time, and this constitutes a great cleaning up and simplification of the code.

We would not tax income originating in other businesses, nor would we tax the business on wages, salaries, and pensions paid by employers.

So if we looked at this form 2, which is on page 12 of the testimony, it is a very short 12-line form, in which gross revenues from sales would be reported, and then businesses would be allowed to deduct their inputs—the purchase of goods, services and materials.

They would deduct the wages, salaries, and pensions which individuals who receive them would report on form 1. And we would replace the current hodgepodge of depreciation schedules, investment tax credits, and the like with a straightforward principle of 100 percent writeoff of all investment spending in the year it took place.

That is, we would expense all investment outlays by business firms. Adding up these two categories would produce the total allowable costs and any net number which remained subtracting those from the gross revenue from sales multiplied by 19 percent would yield taxable income.

To the extent there was a loss on this operation, one would carry the tax loss forward with interest, but we would not allow the Government to write checks to send people this negative sum.

The key points here to highlight are that expensing replaces depreciation, and the system is simple. It becomes a consumption tax in the form of exempting all savings through the exemption of all investment outlays.

There would be no tax on capital gains and financial assets in this system, and this tax would apply to the domestic operations of all businesses whether they are of domestic, foreign or mixed ownership.

I have tried to make this brief, in part, to highlight precisely how simple this integrated tax system is. And I think we should now turn to the very, very important issues of the distribution of the tax burden that would result, the effect of incentives and growth on the economy, and the effect on deficits in the future which my colleague, Professor Hall, will take up.

Mr. HALL. Mr. Chairman, I think the central issue that tax reformers have to address, and the one we will spend a great deal of time on today, is the question of the equity, of the fairness of tax reform.

Congress would never sign onto a new tax system if it thought that it shifted the burden of that tax system toward the poor or even towards middle-income families. Our reform proposal has thought very carefully about the fairness issue. And I think we have found that our approach is one that would be fairer than any other proposal that has been put forward, including certainly the Bradley-Gephardt "FAIR" proposal.

It would be dramatically fairer than the current tax system, which our research reveals to be monstrously unfair. I would disagree strongly with some of the things said in the first panel to the effect that we have a highly progressive tax today. I think the notion that we have a progressive tax today is a joke when one examines the extraordinary amount of income that is received by Americans that never appears on their tax returns.

We estimated the amount of such income to be in the $500 billion range. And we believe that the great bulk of that goes to very high income tax payers.

Consequently, the failure to tax that income, the failure even to report it on tax returns makes the suggestion that we have a progressive or fair tax system today ludicrous. Ours alone among tax reform proposals is one that takes seriously the obligation of this Government to tax all income and not just a select portion of income, in particular, to tax the income that goes to high income American families.

We have developed a technique for carrying out such taxation that goes beyond anything that has been considered by other tax reform proposals.

Now, let me go through in more detail why it is that the Hall-Rabushka proposal is fair.

In the first place, if you examine form 1, you will see that there is a large deduction in the amount of $12,600 for a family of four. That means that income up to that level is not taxed at all.

That puts us ahead of the existing tax system and other reform proposals in putting zero tax rates on the poor and the near poor. We consider that to be a very important foundation of our tax reform proposal.

Then the tax is 19 percent of earnings above the $12,600 level. And we consider that to be an extremely fair approach to the taxation of wage type income.

Now, let me turn to what we call business income. Business income is not just the earnings of capital—that is, the return to savings—but includes a large number of other things. For example, it includes the earnings of the self-employed or partners, lawyers, for example, who typically receive their income as partners, receive what we call business income.

It contains a great deal of income. In fact, our estimate of the amount of business income in the United States today is about $700 billion. So it is a very substantial amount of business income earned in the economy.

Now, if you ask yourself how much tax do we get from business income today, the answer makes it very plain how defective our tax system is today, especially the way that it treats the rich. Currently, counting both the corporate and the personal income tax, the total tax revenue from the taxation of business income is about

$70 billion. Remember that there is almost $700 billion of that income. The tax rate that we put on business income in the tax today is only about 11 percent—in spite of the fact that we have a 46 percent corporate rate, and a top marginal rate, the marginal rate that is applicable to high income Americans, of 50 percent.

Both those tax rates are a joke in terms of the amount of revenue that they generate. Together applied to a total tax base of almost $700 billion, those two tax rates only generate $70 billion.

Now, that, I would argue, is a totally unfair situation in the economy. If we compare that to the way wages are taxed today, the average tax rate on wages is 15 percent. We tax wage income at a substantially higher rate than we tax business income.

Now, that is totally unfair, because business income goes to wealthy Americans, very disproportionately business income goes to the people who are well off. Those who pay the heaviest burden today are the somewhat higher than average salary earners.

But they are not rich by any means. They pay typically a marginal tax rate of up to 50 percent. They are the only people who pay such a tax rate.

On the average wages and salary earners, counting everybody from the lowest to the highest level of wage and salary, pay a 15 percent tax rate, which is a very high average tax rate.

The flat tax would reverse the completely unfair situation. The flat tax would put a 19 percent air-tight rate on business income, and counting the large $12,600 deduction allowance for a family of four, the rate that would be applied to wage income would be about 12 percent.

So let me go over the numbers once again, because I think they tell almost the whole story of the fairness of this tax reform. Today we tax business income at 11 percent and wage income at 15 percent.

What we should do is tax business income at 19 percent and wage income at 12 percent. That reversal would put the burden of the tax system where it belongs, which is on people with high incomes, not on where it is today, which is on wage earners.

So that is really the main message that we would like to give to you today about what the flat tax would do in the economy. It would have other desirable effects. Let me go over them more briefly.

The correction of distortions in the tax system is a very major purpose of our proposal.

We believe that the high marginal rates, 46 percent on corporate business and 50 percent on successful individuals taxed under the personal tax, imposes grave distortions on the economy even though those high rates, especially the high business rates, collect very little revenue. We believe such high rates cause people to become utterly unwilling to show any income on their tax returns, and they do so by engaging in very inefficient tax shelter activities.

Let me just give you an example of the importance of tax shelters in the tax system today. When Congress designed the income tax system, it observed that a large number of people are quite well off, receiving their income in the form of partnerships. It makes sense to tax partnerships, and we do. A partnership return is included as part of an individual's personal tax and the income goes on form 1040 and is taxed in principle under the tax system today.

If Congress decreed that all partnerships were to be tax free, that would raise revenue, because partnerships today are a drain on Federal revenue. Partnerships generate negative income in total. And, therefore, if every lawyer in the United States were declared to be tax free and every other person who is taxed under partnership arrangements were tax free, that would raise revenues.

Mr. Chairman, I consider that a shocking situation in the tax system today, and one that calls for an immediate tax reform in the direction of taxing all income at a reasonable rate, 19 percent.

The same shocking fact is true of other categories of income. Congress, again, thought the people earning rents should make a contribution to paying for the Federal Government. But if rental activities were considered tax free today, it would raise revenue. If farming were considered tax free today, it would raise revenue. If small business today were considered tax free, it would raise revenue.

All those areas are a drain on Federal revenue through the importance of tax shelters. That is unacceptable to me. And to straighten that out, to get the incentives correct, to get the activities out of tax shelters and into productive activities, which is what the effect of a national tax would be, is the major goal that we have in mind. We believe that if the tax system could be straightened out in that way, that over time it would make an important contribution to further economic growth.

Specifically, based on some very substantial research conducted both by ourselves and others, we believe that the total contribution of improved incentives woud be to raise real GNP by about nine percent over the next decade. Now, we want to contrast that with, I think, unrealistic supply-side economics, which we don't subscribe to, but when you look carefully at the way disincentives operate in the tax system today and how they would be improved by a 19 percent flat tax rate, we believe that it is reasonable to project a decade growth to that extent.

An effect of the flat tax that is very important, which I cannot go into now, but is laid out in detail in our written testimony, is that it would lower interest rates. We think that interest rates today, which are, say, 13 percent, would fall to about 10 percent, thanks to the effect of the flat tax. And that would have a major stimulative effect in the economy, and particularly would completely offset in our work the problem that real estate would face under other tax reform proposals related to the denial of mortgage interest deduction.

We agree with limiting—in effect, denying mortgage interest deduction. But we would give to homeowners and commercial real estate something to make up for that in lower interest rates, and that is an immediate, almost mechanical effect of the proposal we have in mind.

In addition, we have formulated a transition proposal which would protect existing homeowners from losing the economic advantage of their mortgage interest deduction. So the reputation of the flat tax, that it is a danger to real estate, is quite incorrect.

Counting something we have always known about, that it would reduce interest rates, and our new transition proposal to protect existing mortgages, together we have completely eliminated any possibility of damage to real estate, either commercial or homeowners, that might come through tax reform.

I think in fact you will find that real estate interests will line up behind the flat tax as they discover these favorable effects to the economy that will occur.

With respect to the deficit, we have done something I don't think other economists have done—certainly CBO has not done it. We have projected the deficit into the 1990's as well as through 1989. We find that with respect to the current tax system, the CBO numbers for the deficit are reasonable through 1989. We agree with them.

But when we project on exactly the basis they have done, and with the current tax system, we find that the deficit gradually disappears during the 1990's, even with the current revenue system. As an economist I feel that the right way to look at the deficit issue is to take debt as a percentage of GNP. It turns out it rises from 39 percent to slightly under 50 percent, and then begins to subside. The natural tendency for revenue to grow faster than program spending will gradually get rid of the deficit.

With the flat tax, which has some advantages on the revenue side as time goes by relative to the current system, plus our projection that over a decade it would add to economic growth, the deficit would disappear more rapidly and cause the debt as a percent of GNP to rise to only 40 percent.

Both with respect to the current system and with respect to the flat tax even more, I do not see that the deficit is a major danger to the economy today. I would caution you to go slow on revenue raising proposals. I think we can live with the deficit situation as long as we keep revenue and spending on the CBO track. Because if we do, relief will occur in the 1990's, even though things will not look so good during the 1980's.

There is no deficit emergency. There is no need to adopt a value-added tax rate or higher tax rates or even the flat tax with a higher than 19-percent rate; there is no emergency that calls for dramatically higher tax rates. Certainly we would not oppose a flat tax with a rate of 20 or 21 percent. But we would be against jacking up the flat tax rate to the level of 23 or 24 percent that would be necessary to close the deficit today.

Economic growth in line with the CBO projection—not anything that has been proposed by the administration higher than that—ultimately in the 1990's will take care of the problem in a way that is economically safe. Therefore, contrary to almost all other witnesses today, and I think economists, I think we should go slow on antideficit moves. I think the situation is not nearly as dangerous as some other people have suggested.

We can live with the current situation. It is not ideal. But we can live with it and relief is coming in the 1990's.

Thank you.

[The prepared statement follows:]

STATEMENT OF ROBERT E. HALL AND ALVIN RABUSHKA, STANFORD UNIVERSITY, ON THE FLAT TAX ON BUSINESS AND WORKERS: EFFECTIVE AND FAIR TAX REFORM [1]

SUMMARY

1. The Hall-Rabushka flat tax plan puts an airtight tax at the low rate of 19 percent on all income.
2. The plan is fair to wage-earners because it permits a large allowance of $12,000 for a family of four. The family pays a tax of 19 percent of its earnings above the allowance.
3. The current tax system, and proposed reforms, are dramatically unfair because they put very low taxes on business income. Under the current tax system, the average tax paid on business income is only about 11 percent. The flat tax would raise this rate to 19 percent.
4. All wage-earners would pay less tax under Hall-Rabushka than under the current tax. The reduction in taxes on wages is possible because of the improved revenue from taxing business income effectively.
5. Although the flat tax would raise more revenue from busines income, it would reduce the distortions of the present tax system, which has very high rates even though it collects little revenue.
6. The flat tax has one uniform, effective investment incentive: first-year writeoff. As a result, the flat tax has the effective of a consumption tax. The flat tax is much simpler and more practical and provides all of the economic benefits of the cash-flow consumption tax.
7. Transition provisions of the flat tax protect homeowners with existing mortgages, together with other borrowers, against the impact of the loss of deductions.
8. At the 19 percent rate, the flat tax would eliminate the deficit in the 1990s. Deficits under the flat tax would be tolerable over the next decade; the ratio of the national debt to gross national product would rise only slightly above its current, safe level.

INTRODUCTION

Within the coming year, Congress will have to come to grips with the crisis in taxation. Our present tax system generates remarkably little revenue even with unacceptably high tax rates. Its unbelievable complexities combine subsidies for taxpayers in some areas, self-defeating high tax rates in others, and a maze of special provisions that often crimp or mis-direct economic development. One defect of the existing income taxes stands above all others. It is grossly unfair to working Americans. Taxes on business income are much lower than those on wages.

There is broad agreement on the solution: We should simplify the tax system, bring in hundreds of billions of dollars of income, especially business income, that currently escape taxation, and reduce tax rates. The witnesses at these hearings, and taxation experts in general, are in agreement on this point.

Our testimony relates to the flat tax plan we developed three years ago. What sets our plan above others is its attention to the problem of the taxation of business income. Our plan overcomes the inequity of the existing tax system by putting an airtight tax on businesses that ensures that business income, which flows largely to the rich, is taxed fairly. No other tax reform plan has addressed this issue effectively.

Under the current tax system and all other tax reform proposals, almost all of the income generated in businesses escapes taxation within the businesses; the hope is that it will be taxed when it makes its way to individuals. For example, corporations are not taxed on the income they pay out as interest. Instead, the people who receive the interest are supposed to pay tax on it. But many do not, either legally or illegally. Rather than tighten up the taxation of the interest received by tens of millions of individuals, it would be simpler and more efficient to collect the tax at the source of the income—in the business. No other tax reform proposal has taken advantage of this simple point.

The business tax is airtight on interest income because businesses are not allowed to deduct the interest they pay on bonds and loans in their business tax computations. The business tax is simply 19 percent of:

Total revenue from sales;

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[1] Hall is Senior Fellow of the Hoover Institution and Professor of Economics. Rabushka is Senior Fellow of the Hoover Institution. For further information, write to either at the Hoover Institution, Stanford University, Stanford, California 94305.

Less wages paid; and

Less purchases of goods and services from other businesses for use in the business, resale, or investment.

Gone are all the complexities of the corporate income tax, including the investment tax credit and deductions for depreciation and interest. The flat business tax provides one simple, comprehensive incentive for capital formation: All investment purchases are deducted for tax purposes.

Because the business tax would put an airtight 19 percent tax on all business income, the only other type of income that would need to be taxed is wage income. We propose a flat tax of 19 percent on wages above a generous exemption level. The exemption would be $12,600 for a family of four. For such a family with $15,000 in earnings, the calculation of the tax is:

Earnings	$15,000
Less exemption	12,600
Taxable earnings	2,400
Tax at 19 percent	456

By contrast, the tax paid by such a family today would be around $900. As a general matter, families with low wage incomes will pay less under the flat tax than they do today, because of the exemption. Families with high salary incomes will also pay less, because of the reduction of the tax rate to 19 percent from the top rate today of 50 percent. We agree with other tax reform proposals that the 50 percent rate is excessive. Even families with earnings at intermediate levels will pay somewhat less tax under the flat tax, contrary to what the critics of the flat tax have claimed.

Under the flat tax, the total burden of taxation on wage income is reduced, and this reduction is shared by all levels of income. The reduction is made possible by the increase in business taxation. The key to the success of the flat tax is its flat business tax. No tax reform can achieve fairness, simplicity, low rates, and high revenue if it does no more than monkey with the deductions and tax rates in the personal income tax. The real problem with the income tax today is the income that never is reported at all anywhere on Form 1040. It takes something like the flat business tax to take care of this problem.

Because the flat tax on business and workers shifts the burden of taxation from wage income to business income, and because most business income is earned by the rich, the flat tax is more progressive than the present tax system or any other proposed reform. The flat tax would be a major move toward fairness.

THE PROPOSAL

Our system replaces the personal and corporate income taxes with a flat tax that puts a low tax rate on a comprehensive definition of income. Because its base is so broad, the tax rate is an astonishingly low 19 percent to raise the same revenue as the current tax system. The tax on individuals is fair and progressive—the poor pay no tax at all, and the fraction of income people pay in taxes rises with income. The system is simple and easy to understand and comply with—tax returns for both families and businesses are simple enough to fit on postcards. And the tax operates on the consumption tax principles—people are taxed on what they take out of the economy, not what they put into it.

Our system rests on a very basic administrative principle: Income should be taxed exactly once, as close as possible to its source. This principle seems obvious enough, but the tax system of the U.S. today violates it repeatedly. Some kinds of income—like fringe benefits—are never taxed at all. Other kinds, like dividends, are taxed twice. And interest income, which is supposed to be taxed once, actually escapes taxation completely in all too many cases, where clever taxpayers arrange to receive interest in a way that escapes the income tax.

In our plan, all income is taxed at the same rate. Equality of tax rates is the crux of the flat-rate. Its logic is much more profound than just the simplicity of the tax calculation with a single tax rate. Whenever different forms of income face different tax rates, or different taxpayers face different tax rates, the public takes full advantage of the opportunities to receive income in ways involving low rates. When the tax system permits deductions, deductions will be taken as often as possible against the income that pays the highest tax. All these inequities and inefficiencies can be swept away in one stroke by imposing equal tax rates on all income.

Limiting the burden of taxes on the poor is a central principle of tax reform. Tax systems like a federal sales tax or a value-added tax on businesses would make all citizens, rich and poor alike, pay essentially the same fraction of their incomes in taxes. The current federal tax system avoids taxing the poor, and we think it should stay that way. But again we stress that exempting the poor does not require graduated tax rates, rising to high levels for upper-income families. Graduated taxes automatically create differences among taxpayers in tax rates, and all the attendant opportunities for leakage. A flat rate, applied to all income above a generous personal allowance, provides progressivity without creating differences in tax rates.

Every tax system involves decisions about taxes on the return to saving and on investment incentives. The current tax system involves an incredible hodge-podge of provisions. As a general matter, it puts substantial tax rates on the earnings from savings. On that account, the economy is biased toward too little saving and too much consumption. But the system has a number of special provisions intended to spur investment and offset the bias. On the business side, there is an investment tax credit for purchases of equipment and accelerated depreciation deductions for both equipment and buildings. On the personal side, savings placed in Keogh and IRA accounts are excused from double taxation; they are taxed only once at the time that retirement benefits are paid out. But the overall effect of the saving-investment incentives are spotty. In the flat tax system, there is a single, coherent provision for taxing the return to saving. All income is taxed, but the earnings from saved income are not taxed further.

We believe that the simplicity of our system is an important feature. Complex tax forms and tax laws do more harm than just the deforestation of America through the Internal Revenue Service's appetite for paper. Complicated taxes require expensive advisors for taxpayers and equally expensive review and audit by the government. A complicated tax invites the taxpayer to search for a special feature that can be twisted to escape the taxation of some income or give an advantageous deduction to some expense. And complicated taxes diminish confidence in government, inviting a breakdown in cooperation with the tax system and widespread outright evasion.

Our flat tax applies to both businesses and individuals. Though our system has two separate tax forms—one for business income and the other for wages and salaries—it is important to think of it as an integrated system. When we speak of its virtues, like its equal taxation of all types of income, we mean the system, not one of its two parts.

In our system, all income in the country is classified as either business income or wages and salaries. The system is airtight; the taxes on both types of income are equal. The wage tax has features to make the overall system progressive. The forms for both taxes will fit on postcards. The low tax rate of 19 percent is enough to match the revenue of the federal tax system as it existed in 1983.

Though our business and wage-salary taxes will replace the present corporate and personal income taxes, it would be a mistake to think if our business tax as the replacement for the corporate tax and our wage-salary tax as the replacement for the personal income tax. Many types of businesses besides corporations will file our business tax form. Even within corporations, vastly more income is covered by our business tax than today's corporate income tax.

Following are the numbers from the U.S. National Income and Product Accounts for 1983 that enable us to project the revenue from the flat tax. All data are in billions of current dollars.

(1) Gross domestic product	$3,263
(2) Indirect business tax	248
(3) Imputed items	237
(4) Wages, salaries, and pensions	1,722
(5) Investment	378
(6) Taxable business income	678
(7) Revenue from the business tax at 19%	129
(8) Taxable wages, salaries, and pensions	1,082
(9) Revenue from wage tax at 19%	206
(10) Total revenue, flat tax	334
(11) Actual personal income tax	290
(12) Actual corporate income tax	44
(13) Total actual revenue, current tax	334

The first line shows total gross national product, the most comprehensive measure of income throughout the economy. The next two lines are items that are included in GNP but would not be taxed under the flat tax. Indirect business taxes are sales and excise taxes. Imputed items are things like the value of the services of owner-occupied houses that are included in GNP that are not part of the cash income that is covered by the flat tax. Wages, salaries, and pensions, line 4, is what would be taxed under the wage tax, Form 1, and would be deducted by businesses on their Form 2s. Investment, line 5, is the amount spent by businesses on purchases of new plant and equipment (each business could also deduct their purchases of used plant and equipment, but these would be included in the taxable income of the selling business and we can net out the deduction of the buyer and the taxable income of the seller). Line 6 shows the taxable income of all businesses, after they have deducted their wages and investment. The revenue from the business tax, line 7, is 19 percent of line 6. Line 8 shows the amount of wages, salaries, and pensions left after deducting all personal allowances from the amount on line 4. The revenue from the wage tax, line 9, is 19 percent of line 8. Line 10 shows the total revenue from the two components of the flat tax. Lines 11, 12, and 13 show the revenue from the personal and corporate income taxes, and the total. Note that the total flat tax revenue on line 10 is, by design, exactly the same as the total revenue from the current tax on line 13.

These computations show that in 1983, the revenue from the corporate income tax with a tax rate of 46 percent was $44 billion. The revenue from our business tax rate at a rate of only 19 percent would have been $129 billion, almost three times as high even though the tax rate is well under half the corporate rate. The substantial revenue the government would derive from the flat business tax is the key to the fairness of our tax system. Because most business income goes to the rich, putting an airtight tax of 19 percent on that income permits a lowering of taxes and tax rates on working people.

The other side of the coin, of course, is that our wage-salary tax yields less revenue than the current personal income tax—$206 billion in 1983 against $290 billion. We are not proposing a massive shift in taxes from wages to capital income. Our wage-salary tax applies just to wages, salaries, and private pensions, whereas today's personal income tax includes unincorporated business income, dividends, interest, rent, and many other kinds of income we put under our business tax instead.

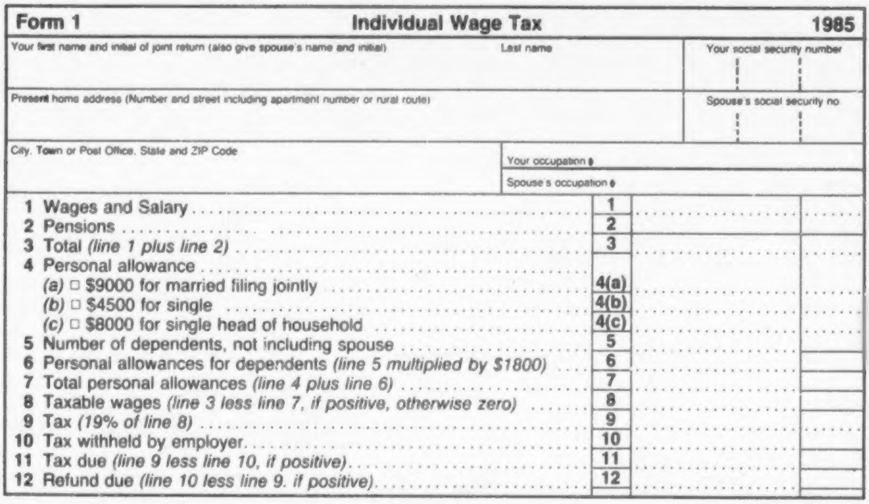
The question we are always asked when we try to explain our system is: Why don't families have to pay tax on their interest, dividends, and other unearned income? Isn't this a tremendous break for the wealthy, who get the vast bulk of that kind of income? The point is that our system does tax this kind of income, at the same rate as all income. Though we will start by describing the wage tax on individuals and families, the way that our complete system taxes all income uniformly won't become clear until we cover the business tax, the most novel part of our proposal.

THE INDIVIDUAL WAGE TAX

The individual wage tax has a single purpose—to tax the large fraction of total income paid as cash by employers to workers. It is not a tax system in itself, but one of two major parts of a complete system. The base of the tax is stated precisely and narrowly as actual payments of wages, salaries, and pensions. Pension contributions and other fringe benefits paid by employers are not counted as part of wages. In other words, the tax on pension income is paid when the retired worker actually receives the pension, not when the employer sets aside the money to pay the future pension.

The tax return for the wage tax is almost self-explanatory:

HALL-RABUSHKA SIMPLIFIED FLAT-RATE TAX FORM



Form 1 **Individual Wage Tax** **1985**

Your first name and initial of joint return (also give spouse's name and initial) Last name

Your social security number

Present home address (Number and street including apartment number or rural route)

Spouse's social security no

City, Town or Post Office, State and ZIP Code

Your occupation ▸

Spouse's occupation ▸

1 Wages and Salary	1		
2 Pensions	2		
3 Total *(line 1 plus line 2)*	3		
4 Personal allowance			
(a) ☐ $9000 for married filing jointly	4(a)		
(b) ☐ $4500 for single	4(b)		
(c) ☐ $8000 for single head of household	4(c)		
5 Number of dependents, not including spouse	5		
6 Personal allowances for dependents *(line 5 multiplied by $1800)*	6		
7 Total personal allowances *(line 4 plus line 6)*	7		
8 Taxable wages *(line 3 less line 7, if positive, otherwise zero)*	8		
9 Tax *(19% of line 8)*	9		
10 Tax withheld by employer	10		
11 Tax due *(line 9 less line 10, if positive)*	11		
12 Refund due *(line 10 less line 9, if positive)*	12		

To limit the burden of the tax on poor families, only earnings above a personal allowance are taxed. The allowance is $12,600 for a family of four in 1985, but would grow along with the cost of living in later years. All the taxpayer has to do is report total wages, salaries, and pensions at the top, compute the personal allowance based on marital status and number of dependents, subtract the allowance, multiply by 19 percent to compute the tax, take account of withholding, and pay the difference or apply for a refund. For about 80 percent of the population, filling out this postcard once a year would be the only effort imposed on them by the federal tax system. What a change from the many pages of schedules filled out by the typical frustrated taxpayer today!

At a low flat rate of 19 percent, the individual wage tax generates a large fraction of the revenue needed by the federal government. In 1983, wages, salaries, and private pensions were about $1722 billion. Personal allowances that would have been deducted were about $640 billion (this estimate takes into account the number of people who would not be able to deduct the full amount of the allowance because their earnings were below the allowance). Tax revenues would have been $206 billion. For comparison, the personal income tax produced $290 billion in revenue in 1983.

For the 80 percent or so of the population who receive no business income directly, the individual wage tax is the only tax they will have to worry about. Many features of current taxes will disappear. Charitable deductions will no longer exist—we will have much more to say on this controversial subject in a later section. Deductions for mortgage and other interest payments will vanish, as part of the general plan to put all interest payments on an after-tax basis, an aspect of the business tax we will explain shortly. On the other hand, deductions for business expenses for people like commission salesmen are permitted, because they are among the 20 percent who file the business tax return.

Again we stress that the wage tax is not a complete income tax on individuals. It taxes only wages, salaries, and pensions. The companion business tax picks up all other components of income. Together they form a watertight tax system.

THE BUSINESS TAX

In the first place, the purpose of the business tax is not to tax businesses. Fundamentally, people pay taxes, not businesses. The idea of the business tax is to collect the tax that the owners of a business owe on the income produced by the business. Collecting business income tax at its source avoids the single biggest source of leakage in the tax system today, the avoidance and outright evasion of income tax on interest and dividends. Watertight taxation of individual business income at the source in the business is possible because we already know the tax rate of all of the owners of the business—it is the common flat rate paid by all taxpayers. If the tax system had graduated rates, taxation at the source would be difficult or impossible.

Suppose there were three or four different rates, as some modified flat-rate proposals call for. Then the business would have to find out the tax rate applicable to each of its owners, and apply that rate to the income produced in the business for that owner. The form would have at least five more lines for these computations. But that is only the beginning of the problem. The Internal Revenue Service would have to audit a business and its owners together in order to see that the owners were reporting the correct tax rates to the business. Further, suppose one of the owners made a mistake, and later discovered he was in a higher tax bracket. Then the business would have to refile its tax form to collect the right tax. Obviously this wouldn't work. Business taxes have to be collected from the owners, not from the source, if tax rates are graduated. This is a powerful practical reason for a flat-rate tax.

The business tax is a giant, comprehensive withholding tax on all types of income other than wages, salaries, and pensions. It is carefully designed to tax every bit of income outside of wages, but to tax it only once. The business tax does not have deductions for interest payments, dividends, or any other type of payment to the owners of the business. As a result, all income that people receive from business activity has already been taxed. Because it has already extracted its tax, the tax system need not worry about what happens to interest or dividends after they leave the firm. The resulting simplification and improvement in the tax system is enormous. To take just a single example, the Internal Revenue Service currently puts a great deal of effort into keeping track of trusts. A trust receives interest and dividend income, and the beneficiary of the trust is supposed to pay income tax on that income. Naturally, it is tricky to check that this is being done, and, in any case, if the beneficiary is a child in a low tax bracket, the trust is just a gimmick to take advantage of differences in tax rates. With our business tax, people can be as creative as they want in setting up trusts; the tax is paid before the money arrives at the trust and the Internal Revenue Service can relax. This is really important to the typical person who does not take advantage of trusts, because it increases the taxes paid by those inclined toward gimmicks and avoidance, and so lowers the taxes paid by the typical person.

The way that we have chosen to set up the business tax is not at all arbitrary—on the contrary, it is virtually dictated by the principles underlying our system. The tax is to bear on all the income originating in the business, but is not to tax any income that originates in other businesses, nor is it to tax the wages, salaries, and pensions it pays to its employees. The types of income taxed by the business tax include: profits from the use of plant and equipment; profits from ideas embodied in copyrights, patents, trade secrets, and the like; profits from past marketing and advertising efforts; earnings of key executives and others who are owners as well as employees, and who are paid less than they contribute to the business; earnings of doctors, lawyers, and other professionals; rent earned from apartments and offices; and fringe benefits provided to workers.

The business tax works in the following way: All income derives fundamentally from the sale of the products and services produced by the business. On the top line of the business tax form goes the gross sales of the business—the proceeds it received from the sale of all of its products. But some of the proceeds amount to the resale of things the firm purchased; the tax is already paid on them because the seller also has to pay the business tax. So the firm can deduct the cost of all the goods, materials, and services it purchases for the purpose of making the product it sells. In addition, it can deduct its wages, salaries, and pensions, for the taxes on these will be paid by the people receiving them, under our wage tax. Finally, the business can deduct all its outlays for plant, equipment, and land. A little later we will explain why this investment incentive is just the right one.

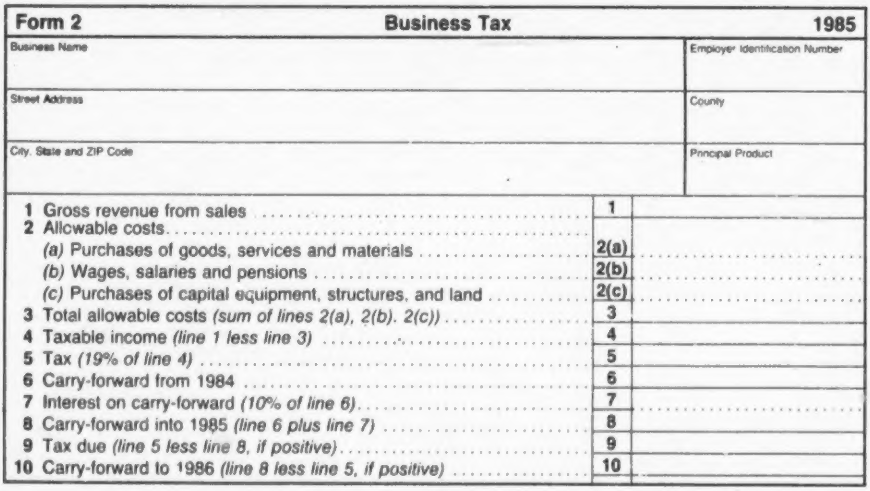
Everything left from this calculation is the income originating in the firm, and is taxed at the flat rate of 19 percent. In most American businesses, a lot is left, and the revenue from the business tax is substantial. Many deductions allowed business under current laws are eliminated in our plan—these include interest payments and fringe benefits. But our exclusion of these deductions is not an arbitrary move to increase the tax base. In all cases, the elimination of deductions, when combined with the other features of our system, moves toward the goal of taxing all income once at a common, low rate.

Eliminating the deduction for interest paid by businesses is a central part of our general plan to tax income at the source. It makes sense because we do not propose to tax the interest receipts of individuals. The tax that the government hopes that individuals will pay (often vainly) is paid for sure by the business itself.

We sweep away the whole complicated apparatus of depreciation deductions, but we replace it with something more favorable for capital formation, immediate 100 percent first-year tax writeoff of all investment spending. We don't deny depreciation deductions; we enhance them. More on this shortly.

Fringe benefits are outside the current tax system completely, which makes no sense. The cost of fringes is deductible by businesses, but workers are not taxed on the value of fringes. Consequently fringes have a big advantage over cash wages. As taxation has become heavier and heavier, fringes have become more and more important in the total package offered by employers to workers—fringes were only 1.2 percent of total compensation in 1929, when income taxes were unimportant, as against 16.4 percent in 1983. The explosion of fringes is strictly an artifact of taxation, and is an economically inefficient way to pay people. Were the tax system neutral, taxing fringes at the same rate as cash wages, people would rather take their income in cash and make their own decisions about health and life insurance, country club dues, exercise facilities, and all the other things they get now from their employers without much choice. Furthermore, failing to tax fringes means taxes on other types of income are all the higher. Bringing all types of income under the tax system is essential for low rates. Here is the simple form each business would file under our system:

HALL-RABUSHKA SIMPLIFIED FLAT-RATE TAX FORM



Form 2 **Business Tax** **1985**

Business Name
Employer Identification Number
Street Address
County
City, State and ZIP Code
Principal Product

1 Gross revenue from sales	1	
2 Allowable costs		
(a) Purchases of goods, services and materials	2(a)	
(b) Wages, salaries and pensions	2(b)	
(c) Purchases of capital equipment, structures, and land	2(c)	
3 Total allowable costs *(sum of lines 2(a), 2(b). 2(c))*	3	
4 Taxable income *(line 1 less line 3)*	4	
5 Tax *(19% of line 4)*	5	
6 Carry-forward from 1984	6	
7 Interest on carry-forward *(10% of line 6)*	7	
8 Carry-forward into 1985 *(line 6 plus line 7)*	8	
9 Tax due *(line 5 less line 8, if positive)*	9	
10 Carry-forward to 1986 *(line 8 less line 5, if positive)*	10	

Even the largest business—the Exxon Corporation in 1983 with $94 billion in sales—would fill out this simple postcard form. Every line on the form is a straightforward, well-defined number obtained directly from the business's accounting records. Line 1, gross revenue from sales, is the actual number of dollars received from the sales of all the products and services of the business, plus the proceeds from the sale of plant, equipment, and land. Line 2a is the actual amount paid for all the inputs necessary for the operation of the business. The firm could report essentially anything it purchased provided it was actually needed for its products and was not being given to the employees or owners. Line 2b is the actual cash put in the hands of workers and former workers. Everything deducted on this line must be reported by the workers in their wage tax returns. Line 2c reports purchases of new and used capital equipment, buildings, and land. Note that the firm doesn't have to agonize over whether a screwdriver is a capital investment or a current input—both are deductible, and the government doesn't care which line it appears on.

The taxable income computed on line 4 bears little resemlence to anybody's notion of profit. The business tax is not a profit tax. When Apple Computer is having an outstanding year in sales and profits, but is building new factories to handle rapid growth, it may well have a low or even negative taxable income. That's fine—later, when expansion slows but sales are at a high level, the income generated at Apple will be taxed at 19 percent and will make its appropriate contribution to financing the federal government.

Because the business tax treats investment in plant, equipment, and land as an expense, companies in the startup period will have negative taxable income. But the government does not write a check for the negative tax on the negative income—

whenever the government starts writing checks, clever people will abuse the opportunity through fraud and legal maneuvers. Instead, the negative tax is carried forward to future years, when the business should have positive taxable income. There is no limit to the number of years of carry-forward. Moreover, balances carried forward earn the market rate of interest (10 percent in 1985). Lines 6 through 10 show the mechanics of the carry-forward process.

INVESTMENT INCENTIVES

The high tax rates of the current tax system significantly impede capital formation. On this point almost everybody agrees. The government's solution to the problem has been to pile one special incentive on another, creating a complex and unworkable maze of regulations and tax forms. Existing investment incentives are appallingly uneven in their effect. Capital projects taking full advantage of accelerated depreciation, the investment tax credit, and the deductability of interest are actually subsidized by the government, not taxed at all. But equity-financed projects not eligible for fast depreciation are taxed heavily. Investment incentives serverely distort the flow of capital into the most favored areas.

We propose to start over by throwing away all of the present incentives and replacing them with a simple, uniform principle—the total amount of investment is treated as an expense in the year it is made. The first virtue of this reform is simplicity. The business and the government need not quarrel, as they do now, over what is an investment and what is a current expense. The distinction doesn't matter for the tax. Complicated depreciation calculations, carrying over from one year to the next and driving the small business owner to distraction and the expense of professional tax assistance, vanish from the tax form. The even more complicated provisions for recapturing depreciation when a piece of equipment or a building is sold will vanish as well, to everyone's relief. All the complexities of the investment credit—what investments are eligible, whether the project lasts long enough to earn the full credit, what fraction of a plant is actually equipment and therefore receives the credit, and the recapture of the credit when an asset is sold—disappear along with the credit.

Expensing of investment has a much deeper rationale than simplicity. Every act of investment in the economy ulitmately traces back to an act of saving. Exempting investment from taxation is the same thing as exempting saving. A tax on income with an exemption for saving is in effect a tax on consumption, for consumption is the difference between income and saving. Consumption is what people take out of the economy; income is what people contribute to the economy. A consumption tax is the exact embodiment of the principle that people should be taxed on what they take out, not what they put in. The simple tax, with expensing of investment, is precisely a consumption tax.

Expensing investment eliminates the double taxation of saving; this is another way to express the most economically significant feature of expensing. Under an income tax, people pay tax once when they earn and save, and pay tax again as the savings earn a return. With expensing, the first tax is abolished. Savings is in effect deducted in computing the tax. Later, the return to the saving is taxed, through the business tax. Though economists have dreamt up a number of other ways to eliminate double taxation of saving (most involving complicated record-keeping and reporting by individuals), the technique exploited in the simple tax is by far the most straightforward.

The easiest case for showing that expensing of investment is a consumption tax arises when somebody invests directly in his own business. Suppose a taxpayer receives $1000 in earnings and turns around and buys a piece of business equipment for $1000. He has to pay $190 in taxes on the earnings, but he gets a deduction worth $190 in reduced taxes for the equipment purchases. On net, he pays no tax. He has not consumed any of the original $1000 either. Later, he will receive business income representing the earnings of the machine. This income will be taxed at 19 percent. If he chooses to consume rather than invest again, he will have paid a 19 percent tax on his consumption. The effect of the tax is to tax consumption at 19 percent.

Most people don't invest directly by purchasing machines themselves. Instead, they invest in firms by purchasing shares or bonds and then the firms do the investment in equipment or buildings. Nonetheless, the tax system we propose taxes the consumption of individuals. Suppose the same taxpayer pays the $190 tax on the same $1000 and puts the remaining $810 into the stock market by purchasing a share representing one machine. The share pays out to its owner all of the after-tax earnings of the equipment. How much does a share cost? The issuing firm has to by the machine for $1000 but it gets a tax deduction worth $190. It has to charge at least $810 in order to break even. But if it tries to charge more than $810, other firms will under-bid it to try to capture the profit available. As a result, shares will sell for $810. Our taxpayer can buy a claim on a $1000 machine with his $810 investment. The discount in the stock market just offsets the tax he paid; the discount is the economic equivalent of the tax deduction he could have taken if he had invested directly.

Another possibility for the taxpayer is to buy a bond for $810. Again, the firm issuing the bond can buy a $1000 machine with the $810, after taking advantage of the tax deduction. In order to compete with the returns available in the stock market, however, the bond must pay the same returns as does a stock selling for the same price, which in turn is equal to the after-tax earnings of the machine. So it doesn't matter how the taxpayer chooses to invest his funds. In all cases, he effectively pays no tax if he chooses to save; he only pays the tax when he decides to consume.

In our system, any investment, in effect, has the same economic advantage that a Keogh or Individual Retirement Account has in the current tax system. And we achieve this desirable goal by *reducing* the amount of record-keeping and reporting. Today, taxpayers have to deduct their Keogh-IRA contributions on their form 1040s, they have to file reports each year with the IRS for their funds, and then they have to declare the distributions from the funds as income when they retire. Moreover, proponents of the "cash-flow" consumption tax (sometimes erroneously called "the" consumption tax) would extend their requirements to all forms of saving. Our system accomplished the same thing exactly without any forms or record-keeping.

CAPITAL GAINS

Capital gains on rental property, plant, and equipment are taxed under the business tax. The purchase price is deducted at the time of purchase, and the sale price is taxed at the time of the sale. Every owner of rental real estate would be required to fill out the simple business tax return.

Capital gains in the overall value of a successful firm are also taxed under the new business tax and should not be taxed again at the household level. To see this point, consider the case of the common stock of a corporation. The value of its stock in the market is the capitalization of its future earnings. Because the owners of the stock receive the earnings after the corporation has paid the business tax, that tax depresses the stock's market value. When the market learns that future earnings are likely to be higher than previously thought, the stock rises in value and its owners receive capital gains. When the high earnings materialize in the future, they will be correspondingly taxed. To tax the immediate capital gains of the stock would be double taxation. Thus with comprehensive taxation of business income at the source, capital gains should be excluded from taxation at the household level.

Another way to see that capital gains should not be taxed separately under the flat tax is to look at the national income accounts. Gross national product, the most comprehensive measure of the nation's command over resources, does not include capital gains. The base of the flat tax is GNP less investment and government, which is consumption. To include capital gains in the flat tax base would depart from the principle that it is a tax on consumption.

Capital gains on owner-occupied houses are not taxed under the simple flat tax. Ideally, unexpected capital gains not associated with general inflation should be taxed. However, separating these from other sources of gains is not practical. Very few capital gains on houses are actually taxed under the current tax system, and we would propose to leave the situation unchanged.

IMPORTS, EXPORTS, AND MULTINATIONAL BUSINESS

Many large corporations own subsidiaries overseas. Should the U.S. government attempt to tax businesses owned by Americans, operating entirely outside the U.S.? Current tax law makes a pathetic attempt to tax them, but encounters an obvious problem. Businesses in other countries naturally pay taxes to those countries, and it is not realistic to extract much more tax for the U.S. Current law provides a generous credit for foreign taxes, whose effect is almost to eliminate taxation of overseas operations.

We favor the straightforward principle that the U.S. tax applies only to the domestic operations of all businesses, whether of domestic, foreign, or mixed ownership. Only the revenue from sales of products sold within the U.S. plus the value of products as they are exported is to be reported on the top line of the business tax form. Only the costs of labor, materials, and other inputs purchased in the U.S. or imported to the U.S. are allowable on the second line as deductions for the business tax. Physical presence in the U.S. is the simple rule that determines whether a purchase or sale is included in taxable revenue or allowable cost.

To see how the business tax would apply to foreign trade, consider first an importer selling its wares within the U.S. Its costs would include the actual amount it paid for its imports, valued as they entered the U.S.—this would generally be the actual amount paid for them in the country of their origin. Its revenue would be the actual receipts it obtained from sales in the U.S. Second, consider an exporter selling goods produced in the U.S. to foreigners. Its costs are all of the inputs and compensation paid in the U.S., and its revenue is the amount received from sales to foreigners, provided that the firm did not add to the product after it departed the U.S. Third, consider a firm that sent parts to Mexico for assembly, and brought back the final product for sale in the U.S. The value of the parts as they left the U.S. would count as part of the revenue of the firm, and the value of the assembled product as it entered the U.S. would be expense. The firm would not be allowed to deduct the costs of its Mexican assembly plant.

Under the principle of taxing only domestic activities, the U.S. tax system would mesh neatly with the tax systems of our major trading partners. If every nation used the simple tax and followed the principle, all income throughout the world would be taxed once and only once. Because the principle is already in use in many nations with value added taxes, it makes sense for the U.S. to adopt it as well.

By the same principle, the wage tax applies to the earnings of everyone working within the U.S., whether or not they are Americans, but does not apply to the foreign earnings of Americans.

Choices about the international location of businesses and employment are influenced by differences in tax rates. The U.S., with the low marginal rate of 19 percent, would be much the most attractive location among major industrial nations from the point of view of taxation. Although the simple tax does not tax the overseas earnings of American workers and businesses, there is no reason to fear a mass exodus of economic activity. On the contrary, the favorable tax climate in the U.S. would draw in new business from everywhere in the world.

THE TRANSITION

In our testimony, we are spending the bulk of our effort in laying out how a good, practical tax system would work. We have not made concessions to the political pressures that may well force the nation to accept an improved tax system that falls short of the ideal we have in mind. One area where the political process is likely to complicate our simple proposal is the transition from the current tax to the flat tax. The transition issues that are likely to draw the most attention are depreciation and interest deductions. In both cases, taxpayers who made plans and commitments before the tax reform will cry loudly for special provisions to continue the deductions.

Congress will face a choice between denying taxpayers the deductions they expected before tax reform, or granting the deductions and raising the tax rate to make up for the lost revenue. Fortunately, this is a temporary problem. Once existing capital is fully depreciated and existing bonds have been paid off, the special transition provisions, if any, can be taken off the books.

DEPRECIATION DEDUCTIONS

Existing law lets businesses deduct the cost of an investment on a declining schedule according to a formula that spans around 5 years for equipment and 15 years for buildings. From the point of view of the business, multiyear depreciation deductions are not as attractive as the first-year writeoff prescribed in the flat tax. No businesses will complain about the flat tax as far as future investment is concerned. But businesses may well protest the unexpected elimination of the unused depreciation they thought they would be able to take on the plant and equipment they installed before the tax reform. Without special transition provisions, these deductions would simply be lost.

How much is at stake? In 1981, total depreciation deductions under the personal and corporate income taxes came to $224 billion. At the 46 percent rate for most corporations (which is close to the 50 percent rate paid by the recipients of most business income), those deductions were worth $103 billion. At the 19 percent flat rate, the deductions were worth $103 billion. At the 19 percent flat rate, the deductions would be worth only $43 billion.

If Congress chooses to honor all unused depreciation from investment predating tax reform, it would take about $350 billion out of the tax base for 1985. In order to raise the same amount of revenue as our original 19 percent tax would, the tax rate would have to rise to 21.8 percent, or even a little higher, to the extent that the higher rate depressed economic activity.

Honoring past depreciation would mollify business interests, especially in industries with large amounts of unused depreciation for past investment but little prospect of large first-year writeoffs for future investment. In addition, it would buttress the government's credibility in tax matters by carrying through on a past promise to give a tax incentive for investment. On the other hand, the move would require a higher tax rate and a less efficient economy in the future.

If Congress does opt to honor past depreciation, it should recognize that the higher tax rate needed to make up for the lost revenue is temporary. Within seven years, the bulk of the existing capital would be depreciated and the tax rate brought back to close to 19 percent. From the outset, the tax rate should be committed to drop to 19 percent as soon as the transition depreciation is paid off.

An alternative provision for past depreciation would let firms choose to take the depreciation deductions, but would limit the writeoff for new investment available to firms that made the choice. For example, firms continuing to take past depreciation deductions might be allowed to deduct only half of the purchase price of new investment. They could deduct the other half as soon as they choose not to continue to take old depreciation. The revenue costs of this provision would be smaller, but it would not provide full incentives for new investment to those firms that chose to continue taking depreciation deductions.

INTEREST DEDUCTIONS

Loss of interest deductions and elimination of interest taxation are two of the most conspicuous features of our tax reform. We will discuss the important economic changes that would take place once interest is put on an after-tax basis in a later section. During the transition, there will be winners and losers from the change, and Congress is sure to hear from the losers. Congress may well decide to adopt a temporary transitional measure to help them. Such a measure need not compromise the principles of the flat tax or lessen its contribution to improved efficiency.

Our tax reform calls for the parallel removal of interest deduction and interest taxation. If a transitional measure allows the continuation of deductions for interest on outstanding debt, it should also require the continuation of taxation of that interest as income of the lender. If all deductions are completely matched with taxation on the other side, then a transition provision to protect existing interest deductions would have no effect on revenue. In that respect, interest deductions are easier to handle in the transition that are depreciation deductions.

If Congress decides that a transitional measure to protect interest deductions is needed, we suggest the following. Any borrower may choose to treat interest payments as a tax deduction. If the borrower so chooses, the lender must treat the interest as taxable income. But the borrower's deduction is only 90 percent of his actual interest payment during the year, while the lender's taxable income includes 100 percent of the interest receipts.

Under this transitional plan, borrowers are protected for almost all of their existing deductions. Somebody whose personal finances would become untenable if the mortgage interest deduction were suddenly eliminated can surely get through with 90 percent of his earlier deduction. But the plan provides an incentive for the renegotiation of interest payments. Suppose a couple is paying $10,000 in annual mortgage interest. They can stick with this payment and deduct $9,000 of it per year. Their net cost, after subtracting the value of their deduction with the 19 percent tax rate, is $8,290. The net income to the bank, after subtracting the 19 percent tax it pays on the whole $10,000, is $8,100. Alternatively, they can accept a deal proposed by the bank: The interest payment is lowered to $8,200 by rewriting the mortgage. The couple agrees to forego their right to deduct the interest, and the bank no longer has to pay tax on the interest. Now the couple's cost is the $8,200 (instead of $8,290 without the deal) and the bank's income is $8,200 (instead of $8,100 without the deal). The couple comes out $90 ahead and the bank comes out $100 ahead. The deal is beneficial to both of them.

One of the nice features of this plan is that it does not have to make any distinctions between old borrowing, pre-existing at the time of tax reform, and new borrowing, carried out after reform. Lenders would always require that new borrowers opt out of deductions, and would offer a correspondingly lower interest rate. Otherwise, the lender would be saddled with a tax bill larger than the tax deduction received by the borrower.

As far as revenue, this plan would actually add a bit to federal revenue in comparison to the pure flat tax. Whenever a borrower exercised his right to deduct interest, the government would collect more revenue from the lender than it would lose from the borrower. As more and more deals were rewritten to eliminate deductions and lower interest, the excess revenue would disappear, and we would be left with the pure flat tax.

VARIANTS OF THE FLAT TAX PROPOSAL

In this testimony, we have set forth what we think is the best flat tax. But our ideas are more general than this specific proposal. The same principles could be applied with different choices about the key tradeoffs. The two most important tradeoffs are:

Progressivity versus tax rate. A higher personal allowance would put even a lower burden on low- and middle-income families. But it would require a higher tax rate.

Investment incentives versus tax rate. If the business tax had less than full writeoff for purchases of capital goods, the tax rate could be lower.

Here are some alternative combinations of allowances and tax rates that would all raise the same amount of revenue:

Adult allowance:	*Tax rate*
1,200	15
4,500	19
6,600	23

The choice between these alternatives depends on beliefs about how the burden of taxes should be distributed and on the degree of inefficiency brought into the economy by the corresponding tax rates. We will have more to say on the inefficiency issue shortly.

Here is some alternative combinations of investment writeoffs and tax rates that would all raise the same amount of revenue:

[In percent]

	Structures writeoff	Tax rate
Equipment writeoff:		
100	100	19
84	60	18
66	15	17

The choice among these alternatives depends on the sensitivity of investment-saving to incentives and on the degree of inefficiency brought by the tax rate.

THE FLAT TAX AND THE ECONOMY

Tax reform along the lines of our simple tax will influence the American economy profoundly. Improved incentives for work, entrepreneurial activity, and capital formation will raise national output and the standard of living substantially. Everyone would favor such an economic renaissance. But what about some of the other effects of tax reform? Is it a giveaway to the rich? Will it destroy the housing market by ending mortgage deductions? Can charitable institutions survive without tax deductions for gifts? Can the flat tax end the federal deficit? These are questions that have occurred to almost everybody pondering our radical reform, and they are questions we take seriously.

STIMULUS TO GROWTH

The flat tax at a low, uniform rate of 19 percent will improve the performance of the U.S. economy. Improved incentives to work through increased take-home wages will stimulate work effort and raise total output. Rational investment incentives will raise the overall level of investment and channel it into the most productive areas. And sharply lower taxation of entrepreneurial effort will enhance this most critical input to the economy.

WORK EFFORT

The great majority of economically active Americans would face improved incentives for productive effort under the simple tax. In 1981, married taxpayers had marginal rates under 18 percent only if their taxable income was less than $7600. The majority of families in that year had marginal tax rates of 32 percent or higher and just 16 percent had incomes so low or deductions so high that their marginal rates were below 18 percent. Even these figures understate the improvement in incentives, because many of the couples taxed at low rates are in school or are retired. Only 2 percent of total gross income was earned by couples taxed below 18 percent on the margin. Half of all gross income was taxed at marginal rates of 37 percent or higher. The net effect of equalizing marginal rates at 19 percent is a dramatic improvement of incentives for almost everybody who is economically active. All of our statements have been phrased in terms of married taxpayers because a large fraction of single taxpayers are children or retired people with little likelihood of work or entrepreneurial effort and correspondingly low tax rates.

One point we need to get straight at the very start is that a family's marginal tax rate determines its incentives for all types of economic activity. There is much confusion on this point. For example, some authors have written that married women face a special disincentive because the marginal tax on the first dollar of their earnings is the same as the marginal tax on the last dollar of their husband's earnings. It is true that a woman with a well-paid husband has seriously eroded incentives to work because of high tax rates. But so does her husband. What matters for both of their decisions is how much of any extra dollar of earnings they keep after taxes. Under the U.S. income tax, with joint filing, the fraction either of them takes home after taxes is always the same, no matter how their earnings are split between them.

Sheer hours of work make up one of the most important dimensions of productive effort, and one that is known to be sensitive to incentives. At first, it may seem difficult for people to alter the amount of work they supply to the economy. Aren't most jobs 40 hours a week, 52 weeks a year? It turns out that only a fraction of the work force is restricted in that way. Most of us face genuine decisions about how much to work. Teenagers and young adults—in effect anybody before the responsibilities of parenthood—typically work much less than full time, full year. Improving their incentives could easily make them switch from part time to full time, or to spend less time taking it easy between jobs.

Married women remain one of the largest underutilized resources in the U.S. economy, although a growing fraction enters the labor market each year. In 1983, only 67 percent of all women aged 25 to 54 were at work or looking for work; the remaining 33 percent were spending their time at home, but could be drawn into the market if the incentives were right. There is simply no doubt about the sensitivity of married women to economic incentives. Every study has shown a systematic tendency for women with low after-tax wages and high incomes from their husbands to work very little. Those with high after-tax wages and lower incomes work a lot. It is an altogether reasonable inference that sharply reduced marginal tax rates on married women's earnings will further stimulate their interest in the market.

Another remarkable source of wasted labor power in the U.S. is the early retirement of men. Though 94 percent of men aged 25 to 54 are in the labor force, only 69 percent of those from 55 to 64 are at work or looking for work, and just 17 percent of those over 65. Again, retirement is very much a matter of incentives. High marginal taxation of earnings discourages many perfectly fit men from continuing to work. Because mature men are among the best paid in the economy, a great many of them face marginal tax rates of 30, 40, or even 50 percent. Reduction to a uniform 19 percent could significantly reduce early retirement and make better use of the skills of older men.

An excellent series of studies by MIT economist Jerry Hausman, published by the Brookings Institution and a number of professional journals, has measured the potential stimulus to work effort from tax reform. Although his calculations are just for adult men, it seems reasonable to use them to estimate the overall impact of tax reform—women and teenagers will, if anything, respond even more strongly than adult men to improved incentives. For a flat-rate plan quite similar to ours, Hausman projects an increase in total hours of work in the U.S. economy of about 8 percent. A few workers would reduce their hours, either because the flat rate would exceed their current marginal rate, or because the reform would add so much to their incomes that they would feel that earning was less urgent. But the great majority would face much improved incentives. The increase of 8 percent would be about 3 hours per week on the average, but would take the form of second jobs for some workers, more weeks of work per year for others, as well as more hours per week for those working part time. The total annual output of goods and services in the U.S. economy would rise by about 6 percent, or almost $240 billion. That is nearly $1010 per person—an astonishing sum. Of course, it might take some time for the full influence of improved incentives to have their effect. But Hausman's bottom line is unambiguous: tax reform would have an important favorable effect on total work effort.

CAPITAL FORMATION

Economists are far from agreement on the impact of tax reform on investment. As we have stressed earlier, the existing system puts heavy tax rates on business income, even though the net revenue from the system is small. These rates seriously erode investment incentives. However, generous but erratic investment provisions in the current law and lax enforcement of taxes on business income at the personal level combine to limit the adverse impact. The current tax system subsidizes tax shelter investments—leased equipment, railway boxcars, cable television, oil wells, and the like—while it taxes capital formation heavily when it takes the form of complete new plants. The result has been to sustain capital formation at reasonably high levels, especially since the 1982 recession, but to channel the investment into inefficient uses.

The flat tax has a single, uniform incentive for investment of all types—businesses treat all purchases of capital equipment and buildings as expenses. As we noted earlier, allowing immediate writeoff of investment is considered the ideal investment incentive. A tax system that taxes all income evenly and allows expensing of investment is a tax on consumption. Alan Auerbach, Laurence Kotlikoff, and Jonathan Skinner, then at Harvard, Yale, and the University of Virginia, respectively, have estimated that the use of a flat-rate consumption tax in place of an income tax would raise the ratio of the capital stock to GNP from 3.0 to 4.4. In terms of the U.S. economy in 1985, this means an increase from $12,012 billion to $17,618 billion. Other economists would be less optimistic that the correction of the double taxation of saving would provide the resources for this large an increase in investment. But all would agree that there is some favorable effect on capital formation.

In terms of added GNP, the increase in the capital stock projected by Auerbach and his co-workers translates into 12 percent more goods and services. Not all of this extra growth would occur within the seven-year span we are looking at. But even allowing for only partial attainment in seven years and for a possible overstatement in their work, it seems reasonable to predict an increase in GNP on account of added capital formation of 2 to 4 percent in seven years.

Tax reform would improve the productivity of capital by directing investment to the most productive uses. Alan Auerbach has demonstrated in a paper published by the Brookings Institution that the bias of the current tax system toward equipment and away from structures imposes a small but important burden on the economy. The flat tax would correct this bias. Auerbach estimates that the correction would be equivalent to a 3.2 percent increase in the capital stock. GNP would rise on this account by 0.8 percent.

ENTREPRENEURIAL INCENTIVES AND EFFORT

U.S. economic growth has slowed in the past decade, and surely one of the reasons is the confiscatory taxation of successful endeavors and the tax subsidy for safe, nonentrepreneurial undertakings. There aren't any scholarly studies with quantitative conclusions on the overall benefits from a fundamental shift, but it could be large. Output per hour of work in the U.S. economy today is about 16.7 percent below where it would be if we had followed the growth trend of the 1950s and 1960s. From 1950 to 1973, productivity grew at a robust 2.8 percent per year; since 1973, its growth has been a meager 0.9 percent. The slowdown coincided with the perverse shift in tax incentives associated with the tremendous rise in marginal tax rates in the 1970s.

Today's tax system punishes entrepreneurs. Part of the trouble comes from the interest deduction. The people in the driver's seat in the capital market, where money is loaned and borrowed, are those who lend out money on behalf of institutions and individuals who have figured out how to avoid paying income tax on their interest. These people don't like insecure loans to new businesses based on great new ideas. What they do like is lending secured by mortgages or similar arrangements to readily marketable assets. It's easy to borrow from a pension fund to build an apartment building, buy a boxcar, put up a shopping center, or anything else where the fund can foreclose and sell the asset in case the borrower defaults. Funds won't lend money to entrepreneurs with new ideas, because they are unable to evaluate what they could sell off in case of a default.

Entrepreneurs can and do raise money the hard way, by giving equity interests to investors. An active venture capital market operates for exactly this purpose. But the cost is high to the entrepreneur—the ownership he gives to financial backers deprives him of the full gain in case things work out well.

So far we have just described the harsh reality of trying to get other people to put money into a risky innovative business. Even with the best tax system, or not taxes at all, entrepreneurs would not be able to borrow with ordinary bonds or loans and capture the entire future profits of a new industry. Equity participation by investors is a fact of life. But it is the preverse tax system that much worsens the incentives for entrepreneurs. The combination of corporate and personal taxation of equity investments really is close to confiscatory. The owners of a successful new business are taxed first when the profits flow in, at 46 percent, and again when the returns make their way to the entrepreneur and the other owners. All of them are likely to be in the 50 percent bracket for the personal income tax. Even if they are clever enough to convert every bit of their earnings from the business into capital gains, taxed at 20 percent, the combined effective tax rate is close to 60 percent. The entrepreneur first gives a large piece of the action to the inactive owners, who puts up the capital, and then well over half of the remainder to the government.

The prospective entrepreneur will likely have his attention diverted to the easier life of the investor who uses borrowed money. How much easier to put up a shopping center, borrow from a pension fund or insurance company, deduct everything paid to the inactive investor as interest, and sell out later for a capital gain taxed at only 20 percent. Many of these benefits are available even without any direct involvement—any broker offers dozens of schemes for purchase of cattle, real estate, medical equipment, and a variety of other investments eligible for financing through borrowing. Anybody in the upper-income tax brackets can be an accomplice in the diversion of effort and capital just by making one of these investments.

Today's absurd system taxes entrepreneurial success at 60 percent while it actually subsidizes leveraged investment. Our simple tax would put the same low rate on both activities. A hugh redirection of national effort would follow. And the redirection could only be good for national income. There is nothing wrong with shopping centers, apartment buildings, airplanes, boxcars, medical equipment, and cattle, but the tax advantages have made us invest far too much in them, and their contribution to income is correspondingly low. Real growth will come when effort and capital flow back into innovation and the development of new businesses, where confiscatory taxation has discouraged investment, and the contribution to income from new resources is correspondingly high.

TOTAL POTENTIAL GROWTH FROM IMPROVED INCENTIVES

Take Hausman's estimate of a 6 percent increase in output from increased total work in the U.S. economy. Take a modest additional increment to total output of 3 percent from added capital formation and dramatically improved entrepreneurial incentives. The sum of 9 percent is our best estimate of the improvement in real incomes after the economy has had 7 years to assimilate the changed economic conditions brought about by the simple flat tax. Both the amount and the timing are conservative; they do not remotely resemble the exaggerated claims of the supply-siders.

Even this limited claim for economic improvement represents enormous progress. By 1992, it means each American will have an income about $1750 higher, in 1985 dollars, as a consequence of tax reform.

INCOME DISTRIBUTION AND FAIRNESS

The simple tax does not make everybody better off straight away. Today, heavy taxation of successful salary-earners yields quite a bit of revenue, as well as pushing them out of their most productive undertakings and diverting their attention to tax avoidance. Until a response to improved incentives takes place, it is an obvious mathematical law that lower taxes on some people will have to be made up by higher taxes on others. If tax reform is a zero-sum process, giving relief to some by raising taxes on others, it is politically unlikely. Revitalization of the economy, with more income to divide between the big earners and the rest, is the point of tax reform. However, our flat tax is designed to be fair from the start. It insulates the poor from all taxation. It dramatically limits the taxation of wages and salaries, especially among those who are most successful and productive. It pays for these tax reductions by imposing a sensible tax at a low rate on business income and thus raising the amount of federal revenue collected from businesses.

TAXES ON WAGES AND SALARIES

We will start by looking at a comparison of the current tax and the flat tax for families who have nothing but wage income; these comparisons are relevant for the great majority of Americans.

Here is a comparison of the taxes paid currently and under the flat tax for a family of four in 1985. This family, like most, derives its income from earnings. It consists of two adults and two children. Only one of the adults works and the family does not take a deduction for child care expense (in 1981, the average child care deduction was only $12). The family takes itemized deductions equal to the average in its income category.

	Current tax	Flat tax
Earnings:		
$5,000	0	0
$10,000	$258	0
$15,000	882	$456
$25,000	2,374	2,356
$35,000	4,355	4,256
$50,000	8,189	7,106
$80,000	17,574	12,806

The table shows that people at every level of earnings pay less under the flat wage tax than under the current personal income tax. Below $10,000, neither tax system imposes any tax, in line with the national consensus that the poor should be excused from taxation. For earnings of $10,000 and $15,000, the flat tax is several hundred dollars less than the current tax. The generous allowance of nearly $13,000 under the flat tax keeps the tax burden in this group at a low level. At $25,000 and $35,000 in earnings, the two systems impose essentially the same tax burden. At salaries of $50,000 and $80,000, the flat tax is quite a bit less than today's tax.

The table makes it clear that high-salaried employees get a break under the flat tax in comparison to the current tax. Why do we advocate so generous a break for people who are quite well off? Incentives are the answer. In order to collect $18,534 from an individual with $80,000 in earnings, the current system has to impose a marginal tax rate of 44 percent. For each dollar of extra pay for extra work, this person keeps only 56 cents after income tax. Furthermore, even that high tax rate is no guarantee that anything like this much revenue is actually collected from a family with this much salary. Remember that these computations refer to a family with no income apart from salary. Many people with earnings of $80,000, though, have business interests that generate negative income. Somebody with $80,000 in salary may well actually pay only $5,000 or $10,000 in taxes as a result of negative income. Their taxes will rise with the adoption of the flat tax.

Recall that the flat tax system raises the same revenue as the current system. However, the individual wage tax component of the flat tax raises less revenue than does the personal income tax, and, correspondingly, the business tax component of the flat tax raises more revenue than does the existing corporate income tax. Comparisons like the one we just made are not the end of the story. For those families with interest, dividends, and other business income, we need to think about the taxes that they pay currently on that income under the current personal and corporate income taxes. The income is frequently negative because of tax shelters. We also need to think about the taxes they would pay under the flat business tax.

As we have stressed throughout out testimony, the taxation of business income under the present system is a complete mess. In spite of the burdensome tax rates imposed on business income by the combination of the corporate and personal income taxes, the total amount of tax collected on business income is remarkably small. In 1983, revenue from the corporate income tax was only $44 billion. In addition, the tax paid on all non-wage income reported for the personal income tax was no more than $30 billion. Total revenue from business taxation was no more than $74 billion. By contrast, revenue from taxes on wages under the personal income tax was $260 billion. The average tax rate on business income was only 11 percent, as against over 15 percent on wages. Wage-earners pay much heavier average tax rates than do business owners.

The flat tax would correct this fundamental inequity. The average tax rate on wages would be a little under 12 percent (19 percent on the margin, but less on the average because of the allowances). The average tax rate on business income would be exactly 19 percent. At 1983 levels, business tax revenue would rise from $74 billion under the present tax to $129 billion under the flat tax.

Ideally, we could calculate the impact of the shift to the flat tax on families with various levels of income. The wealthy family with large amounts of business income would pay quite a bit more tax under the flat tax than at present because of the increase in the average tax rate from 11 percent to 19 percent. Unfortunately, we do not know very much about the distribution of business income in the United States. A good deal, but not all, business income goes to the very rich. For example, 61.7 percent of all dividend income goes to families in the top ten percent of the income distribution. In that respect, a shift away from wage taxation and toward business taxation is a progressive move.

Are there enough middle-income families with business income so that their total tax burden, counting both wage and business taxes, would rise after the shift to the flat tax? There is no way to tell. Data from income tax returns show a reasonable number of families whose reported incomes are in the range of $30,000 to $50,000 and who receive substantial business income. But we have no way of knowing how many of them are really middle-income, and how many are actually rich but have succeeded so well in understanding their business income that they appear to be middle-income.

There have to be quite a few families whose business incomes are grossly understated in their income tax returns. By our computations, there was a total of $566 billion in business income earned in the United States in 1981. Only $132 billion in business income was reported on individual returns that year. The chance that a dollar of business income would actually be reported was one in four. On the average, a family whose true business income was $120,000 reported only $28,000 in business income.

We can summarize our conclusions about the distributional fairness of the flat tax as follows:

1. The current personal and corporate taxes tax wages heavily and business income lightly. The flat tax would reverse this inequity and benefit the great majority of Americans, whose income comes almost entirely in the form of wages.

2. In comparison to the current personal income tax on wages, the flat tax would impose a lower burden on low earners and a lower burden on high earners. Those in the middle, around $25,000 in annual wages and salary, would pay about the same in taxes. In the years following tax reform, this group, along with others in the economy, would benefit from increased growth, so it too would come out ahead from the move to the flat tax.

If we are right that improved incentives will actually raise real incomes by 9 percent after 7 years, then it won't take too long for the taxpayers who lose at the outset to come out ahead. The worst immediate impact of the flat tax is to reduce after-tax incomes of people who have been aggressive and successful in keeping business income out of the hands of the IRS or who have created negative business income to offset their salaries. The tax rates on their business incomes will rise from negative or zero to 19 percent. But these people are particularly likely to be able to take advantage of the growth of the economy stimulated by improved taxation.

WHY DO THE CRITICS SAY THE FLAT TAX IS UNFAIR?

Our flat tax plan frequently encounters the criticism that it is unfair. Joseph Minarik and others have claimed that a flat tax inevitably hurts middle-income families. A generous allowance will help the poor, and low marginal rates will help the rich, but the middle class bears the burden of tax reform under the flat tax, according to the critics. William Nordhaus summarized the case in a New York Times article called "The Flat Tax is for Fat Cats."

The critics are wrong. They utterly fail to understand how unfair is our current tax system. Their calculations invariably take the adjusted gross incomes reported by taxpayers as if they were their true incomes. They fail to come to grips with the shocking fact that over three quarters of all business income never shows up in anybody's adjusted gross income.

Because the critics are unware of the additional revenue available from taxing business income effectively at a rate of 19 percent, they examine flat-rate plans that extract excessive revenue from working people. Of course they find that their plans put a heavy burden on middle-income wage and salary workers. They do not consider the option of raising a suitable amount of revenue from business income. Instead, they propose to continue the current practice of generating almost all revenue by having wages and salaries. By letting business income continue to go virtually untaxed, they perpetuate the unfairness of the current tax system.

INTEREST RATES

The simple tax would pull down interest rates immediately. High interest rates today are sustained partly by the income tax deduction for interest paid and the tax on interest earned. Much of the pain of high interest is ameliorated by the tax benefit, and part of the income from interest is taken away by the IRS. Borrowers tolerate high interest rates and lenders require them. The simple tax permits no deduction for interest paid and puts no tax no interest received. Interest payments throughout the economy will be flows of after-tax income, thanks to taxation of business income at the source.

With the simple tax, borrowers are no longer so tolerant of interest payments, and lenders are no longer concerned about taxes. The meeting of the minds in the credit market, where borrowing equals lending, will inevitably occur at a lower interest rate. Potentially, the fall could be spectacular. Much borrowing comes from corporations and wealthy individuals, who face marginal tax rates of 46 and 50 percent. On the other hand, the wealthy, almost by definition, are the big lenders in the economy. If every lender and every borrower were in the 50 percent bracket, simple logic shows that a tax reform eliminating deduction and taxation of interest would cut interest rates in half—for example, from 16 to 8 percent. But the leakage problem in the U.S. is so great that the actual drop in interest would be far short of this huge potential. So much lending comes through the devices by which the well-to-do get their interest income under low tax rates that a drop of half would be impossible. Lenders taxed at low rates would be worse off if taxation were eliminated but interest rates fell by half. The meeting of the minds in an economy with lenders enjoying low marginal rates before reform would have to come at an interest rate well above half the prereform level. But the decline would be at least a fifth—say from 16 percent to 13 percent. Reform would bring a noticeable drop in interest rates.

One direct piece of evidence is available on this point. Municipal bonds yield interest not taxed under the federal income tax. Tax reform would make all bonds like tax-free municipals, so the current rates on municipals gives a hint about the level of all interest rates after reform. In 1984, municipals yielded about 3 percentage points less interest than comparable taxable bonds. But this is a conservative measure of the likely fall in interest rates after reform. Today, tax-free rates are kept high because there are so many opportunities to own taxable bonds in low-tax ways. Why own a bond from the City of Los Angeles paying 10 percent tax-free when you can create a personal pension fund and hold a Pacific Bell bond paying 13 percent? Interest rates could easily fall to three-quarters of their present levels after tax reform; rates on tax-free securities would then fall a little as well.

High interest rates are widely noted as a symptom of a problem in the American economy. But the decline in interest rates brought about just by putting interest on an after-tax basis would not by itself change the economy very much. To U.S. Steel, contemplating borrowing to finance a modern plant, the attraction of lower rates would be offset by the cost of lost interest deductions. In fact, if tax rates on borrowers remained at 50 percent, and interest rates fell by less than half, effective borrowing costs would rise, and the outlook for investment in new plant and equipment would worsen.

The simple tax does much more than put interest on an after-tax basis. Tax rates on corporations are to be slashed—to a uniform 19 percent from the double taxation of 46 percent corporate on top of up to 50 percent personal. And investment incentives are improved through first-year writeoff. All told, borrowing for investment purposes will become a better deal. An investment boom is likely to occur. As the boom develops, borrowing will rise and will tend to push up interest rates. In principle, interest rates could rise to their prereform levels, but only if the boom is vigorous. We can't be sure what will happen to interest rates after tax reform, but we can be sure that high interest, low investment stagnation will not occur. Either interest will fall or investment will take off.

As a safe working hypothesis, we will assume that interest rates fall in the year after tax reform by about a quarter, say from 13 to 10 percent. We assume a quiescent underlying economy, not perturbed by sudden shifts in monetary policy, government spending, or oil prices. Now, take a look at the borrowing decisions before and after reform. Before, an entrepreneur considers an investment yielding one million dollars a year in revenue, involving $800,000 in interest cost at 13 percent interest. The entrepreneur pays 50 percent tax on the net income of $200,000, giving him an after-tax flow of $100,000. After reform, he earns the same $1,000,000, pays $615,000 interest on the same principal at 10 percent. He pays 19 percent tax on the earnings, without deducting interest, for taxes of $190,000. His after-tax income is $1,000,000 − $615,000 − $190,000 = $195,000, well above the $100,000 before reform. Reform is to his advantage, and to the advantage of capital formation. What he loses from denied interest deduction he more than makes back from the lower tax rate.

How can it be that both the entrepreneur and the government come out ahead from the tax reform? They don't—there is one element missing from this accounting. Before the reform, the government collected some tax on the interest paid by the entrepreneur—potentially as much as half the $800,000, but as our stories about leakage make clear, the government is actually lucky to get a small fraction of that potential. To summarize, the simple flat tax automatically lowers interest rates. Without an interest deduction, borrowers require lower costs. Without an interest tax, lenders are satisfied with lower payments. The simple flat tax has an important effect on interest rates. Lower interest rates stimulate the housing market, a matter of great concern to almost everybody.

HOUSING

Everyone who hears about the simple flat tax, with no deductions for interest, worries about its effect on the housing market. Won't the elimination of the deduction depress the prices of existing houses and impoverish the homeowner who can only afford a house because of its interest deductions? Our answer to all of these questions is no, but we freely concede that there is a significant issue here. In all but the long run, house prices are set by the demand for houses, because the supply can only change slowly. If tax reform increases the cost of carrying a house of a given value, then demand will fall and house prices will fall correspondingly. For this reason, we are going to look pretty intensively at what happens to carrying costs before and after tax reform.

If tax reform had no effects on interst rates, its adverse effect on carrying costs and house values would be a foregone conclusion. A $100,000 house with a $50,000 mortgage at 14 percent has interest costs of $7000 per year before deductions and $4900 after deductions for someone in the 30 percent tax bracket. The monthly carrying cost is $408. Take away the deductions, and the carrying cost jumps to $7000 per year or $583 per month. Inevitably, the prospective purchaser faced with this change would have to settle for a cheaper house. Collectively, the reluctance of purchasers would bring house prices down so that the buyers could afford the houses on the market.

As we stressed earlier, tax reform immediately lowers interest rates. And lower rates bring higher house prices, a point dramatically impressed on homeowners in the early 1980s when big increases in interest severely damped the housing market. The total effect of reform depends on the relative strengths of the contending forces—the value of the lost interest deduction against the value of lower interest. We have already indicated that there are good reasons to think interest rates would fall by about 4 percentage points—say from 14 to 10 percent for mortgages. The value of the lost deduction, on the other hand, depends on just what fraction of a house a prospective purchaser intends to finance. First-time home buyers typically, but not always, finance three-quarters or more of the price of a house. Some of them have family money or other wealth, and make larger down payments. Families moving up by selling existing houses generally plan much larger equity positions in their new houses. Perhaps a down payment of 50 percent is the average, so families are paying interest (and deducting) on $500 per thousand dollars of house.

A second determinant of the carrying cost is the value of the deduction, set by the marginal tax rate. Among homeowners, a marginal rate of 30 percent is typical, corresponding to a taxable income of $??,000. Interest carrying costs per thousand dollars of house are $500 borrowed x 14 percent interest = $70 per year before taxes and $49 per year after taxes. When tax reform comes, the interest rate falls to 10 percent, and carrying costs are $500 x 10 percent = $50 per year before and after taxes. Tax reform puts this buyer behind by one dollar per thousand dollars of house per year, or $100 per year for the $100,000 house.

If this $100 per year were the end of the story, it would bring a tiny decline in house prices. But there is another factor we haven't touched on yet. The buyer's equity position—the down payment—must come from somewhere. By putting wealth into a house, the buyer sacrifices the return the wealth would have earned elsewhere. The alternative return from the equity in the house is another component of the carrying cost. Tax reform almost surely reduces that component. As just one example, take a prospective buyer who could put wealth into an untaxed retirement fund if he didn't put it into a house. The fund holds bonds; after reform, the interest rate on bonds would be perhaps 4 percentage points lower, and so the implicit cost of the equity would be lower by the same amount.

To take a conservative estimate, tax reform might lower the implicit cost of equity by one percentage point as interest rates fall. Then the carrying costs of the buyer's equity would decline by $500 x 1 percent = $5 per thousand dollars of house per year. Recall that the buyer has come out behind by $1 on the mortgage interest side. On net, tax reform would lower the carrying costs by $5 — $1 = $4 per thousand, or $400 per year for the $100,000 house. Then housing prices would actually rise under the impetus of tax reform.

We won't argue that tax reform will stimulate the housing market. But we do feel that the potential effects on house prices are small—small enough to be lost in the ups and downs of a volatile market. Basically, reform has two effects—to reduce interest rates and related costs of funds (and so to stimulate housing and other asset markets) and to deny interest deductions (and so to depress housing). To a reasonable approximation, these influences cancel each other out.

If tax reform sets off a rip-roaring investment boom, interest rates might rise in the years following the immediate drop at the time of the reform. During this period, when corporations were competing strongly with home buyers for available funds, house prices would lag behind an otherwise brisk economy. The same thing happened in the great investment boom of the late 1960s. But to get the strong economy and new jobs that go with an investment boom, minor disappointments in housing values would seem a reasonable price. In the long run, higher incomes will bring a stronger housing market.

What about the construction industry? Will a slump in new housing accompany a tax reform that banishes interest deductions, as the industry fears? The fate of the industry depends intimately on the price of existing housing. Were tax reform to depress housing by raising carrying costs, the public's interest in new houses would fall in parallel with its diminished enthusiasm for existing houses. Because tax reform will not actually alter carrying costs in one direction or another, it will not enrich or impoverish the construction industry.

So far, we have looked at the way a prospective buyer might calcualte what value of house he can afford. These calculations are the proximate determinants of house prices. But they have no bearing on the situation of an existing homeowner who has no intention of selling or buying. To the homeowner, loss of the tax deduction would be pure grief.

Our transition proposal takes care of the problem of existing mortgages without compromising the principles of the flat tax or diminishing its revenue. Homeowners would have the right to continue deducting 90 percent of their mortgage interest. Recall that the bank would then be required to pay tax on the interest it received, even though interest on new mortgages would be untaxed. Homeowners could expect to receive attractive propositions from their banks to rewrite their mortgages at about three percentage points lower interest, but without tax deductibility. Even if banks and homeowners could not get together to lower rates, the homeowner could deduct 90 percent of what he deducted before.

CHARITABLE CONTRIBUTIONS

Deductions of contributions to worthy causes would be a thing of the past under our tax reform. Will the nation stop supporting its churches, hospitals, museums, and opera companies when the tax deduction disappears? We think not. But we should also be clear that incentives matter—the current tax system with high marginal rates and tax deductions provides inappropriately high incentives for some contributions. The immediate effect of tax reform may be a small decline in giving. Later, as the economy surges forward under the impetus of improved incentives for productive activity, giving will recover and likely exceed its current levels.

In 1981, total contributions from individuals and corporations to charitable causes in cash and voluntary work were about $?? billion. Of this, only $33.3 billion was deducted on tax returns. The great bulk of contributions were not even affected by the law permitting deduction. We can confidently expect the continuation of the $?? billion in contributions being made today without any special tas benefits. Further, the bulk of contributions is made today by people in modest tax brackets—less than $14 billion in contributions were deducted in 1981 by families with taxable incomes over $35,000. In this connection, it is important to understand that well over half of all cash contributions go to churches, and these gifts are generally from the middle of the income distribution.

Churches have nothing to fear from tax reform, and, like most people and institutions, would have to gain from better economic conditions brought about by reform. In spite of their dominant position in gifts, churches are not the leaders in fighting tax reform that denies deductions. Instead, institutions serving the absolute economic and social elite—universities, symphonies, opera companies, ballets, museums—are protesting the loudest. No compelling case has ever been made that these worthy undertakings should be financed by anybody but their customers. A glance at the crowd in any of them will tell you that it is perverse to tax the typical American in order to subsidize the elite institutions. But granting tax deductions for gifts is precisely such a subsidy.

Tax reform will be a tremendous boon to the economic elite from the start. After all, those with high salaries and few tax shelters will benefit directly and immediately from the reduction in the tax rate from 50 percent to 19 percent. Those with lightly taxed business income stand to benefit more indirectly. Their economic activities are severely distorted by the devices and activities they have adopted to avoid taxes. Freed from these distortions, they may well become better off even though they are paying more taxes. For both groups, removal of tax deductions from their favorite cultural activities us a reasonable price to pay. With substantially higher true after-tax incomes among their customers as well as donors, the universities and other institutions will make up part or perhaps all of the ground they will lose when tax deductions disappear.

The major tax enacted in 1981 (the Economic Recovery Tax Act) cut marginal tax rates from 70 percent to 50 percent for the highest incomes. As a result, major donors shifted from spending 30-cent dollars to spending 50-cent dollars for tax-deductible gifts. In spite of this major reduction in the incentive to give, donations to charity grew robustly. Here are the numbers:

	Tax deductions	Total gifts
Year:		
1979	24	94
1980	28	111
1981	33	118
1982	36	133
1983	NA	145

THE FEDERAL DEFICIT

The federal deficit is one of the most conspicuous problems of the American economy. In fiscal year 1984, the government spent about $172 billion more than it took in. The same thing seems likely to happen in future years. Is the federal government headed for bankruptcy? Is it essential to raise additional revenue in the near future in order to close the deficit? Would the flat tax be a better vehicle for raising the needed revenue?

In our view, the economic significance of the deficit has been overstated by most observers. It is true that the federal government will continue to operate seriously in the red for the rest of the 1980s with the current revenue system and likely future spending. During that period, the national debt will continue to grow. However, the debt will remain small compared to the overall size of the U.S. economy.

Continuing high deficits in the 1980s will conceal a development of major importance: Federal revenue will grow faster than spending on government programs. When the economy grows by one percent, as measured by inflation-adjusted real GNP, revenue will grow by a little more than one percent, again adjusted for inflation. The excess growth of revenue is particularly strong under the existing personal income tax, where growth puts people in higher tax brackets, but it would also occur under the flat tax, because of the exemption. On the other hand, spending on programs will grow somewhat less than GNP. Except in wartime, spending has generally lagged GNP, and the tendency has been particularly strong since 1977. The two factors will combine to improve the budget in each successive year.

The negative factor that will keep the deficit high and rising during the 1980s is interest on the national debt. Each addition of $100 billion in debt adds over $10 billion to the deficit through increased interest expense. Through 1989, the growth in interest will exceed the favorable contribution from higher revenue growth and lower spending growth. But starting in 1990, the favorable influence will begin to predominate. By some time in the 1990s, in fact, the budget will be in balance. This conclusion holds both for the current tax and for the flat tax. Here are our computations for the two tax systems:

	Deficit		Debt as a percent of GNP	
	Current	Flat tax	Current	Flat tax
Year:				
1985	182	188	39	39
1986	200	185	41	41
1987	211	188	43	40
1988	244	194	45	40
1989	262	192	46	40
1990	260	170	47	39
1991	252	142	48	38
1992	239	105	47	36
1993	220	82	47	34
1994	193	53	46	33
1995	157	17	44	30
1996	110	−26	42	28

The problem of the deficit subsides after 1989 under either tax, but progress is quicker under the flat tax. There are two reasons for the superior performance of the flat tax. First, the flat tax lowers interest rates. Under our transition proposal, the government would benefit immediately on all its outstanding debt from the lower interest rates that would automatically accompany a reform that put interest on an after-tax basis. Second, the flat tax stimulates extra economic growth. Because growth raises revenue by quite a bit more than spending, it further helps reduce the deficit.

One of the best ways to assess the economic impact of deficits is by looking at the debt-GNP ratio. Even a very large deficit is not economically harmful if it occurs in a setting where the debt-GNP ratio remains at a suitably low level. When the U.S. emerged from World War II, the debt-GNP ratio was 109 percent, and that did not interfere with the sharp growth of the economy in the postwar years. Even with the existing tax system, the debt-GNP ratio will not reach even 50 percent, a safe level. Under the flat tax, the ratio hardly exceeds its present level of around 40 percent.

We do not see an urgent need for higher tax rates under either the current tax or the flat tax. With continued attention to keeping the growth of program spending below the growth of GNP, the deficit will disappear in the 1990s—in the middle of the decade under the flat tax and the end under the current tax system.

Mr. Heftel. Thank you very much. We will now hear from Mr. Aaron and Mr. Galper.

STATEMENT OF HARVEY GALPER, SENIOR FELLOW, THE BROOKINGS INSTITUTION, AND HENRY J. AARON, SENIOR FELLOW, THE BROOKINGS INSTITUTION, AND PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND

Mr. Galper. Thank you, Mr. Chairman.

We do have a joint testimony. I will speak first, and then Mr. Aaron will follow.

We are pleased to be here today to discuss our views on reforming the Nation's tax structure. As you say, we have recently proposed a cash flow income tax as the fairest, most efficient and simplest way to collect revenues from individuals and corporations.

The appendix attached to our testimony outlines this tax. Today, however, we will not discuss the specific details of the program, but explain why we feel such a change is necessary and why no conventional tax reform of the annual income tax can solve the most serious problems of the current tax structure.

The current tax system, we believe, is in sad shape in two distinct but related ways. First, it simply does not raise enough revenue. And here I would maintain that the deficit is a problem and that part of the way of solving the deficit is to raise additional revenues.

And, second, the tax structure itself is riddled with exemptions, exclusions, credits and other implicit and explicit preferences that distort savings, consumption and investment, befuddle taxpayers, make lawyers and tax shelter indicators rich and produce gross unfairness—the same catalog of ills that other speakers have noted.

With respect to tax reform, we advocate an approach which would deal with the two issues separately. That is revenues should be raised promptly in a way that does not preclude long-run reform and on a parallel track the tax writing committee should continue examining options for structural tax change.

We would urge that the immediate need for additional revenues not lead to the adoption of revenue-raising measures that do not make sense as part of an ongoing revenue structure. In other words, that time be taken to analyze alternatives carefully, thoughtfully, and then make judgments, and that the pressures of short-run revenue need not stand in the way of making longer run judgments on the tax structure.

Income tax reformers for years have been seeking to broaden the tax base by eliminating or reducing itemized deductions, by repealing exclusions, and by eliminating special tax credits. This strategy, however, has not been a smash hit at the political box office.

But even if it had, that approach by itself would still leave important defects in the income tax that would cause inequity, inefficiency and complexity. It is important, therefore, to look at the inherent defects of the income tax. We believe there are four serious shortcomings of the income tax that are not solved by conventional base-broadening tax reform.

The first has to do with the issue of accrual versus realization in some of the income tax; the second, with the interaction of the tax system with inflation; third, the taxation of corporate source income; and, fourth, the effects of the income tax on saving and investment.

We will emphasize these shortcomings because they are root causes of dissatisfaction with the income tax and because none of the proposals for broadening the base of the income tax begins to deal with them in an adequate way.

First accrual versus realizations. The first defect is that the income tax inevitably must be transactions-based and, therefore, is essentially a tax on income as realized not on income as accrued or earned. We do not support an accrual-based system. As a practical matter, trying to tax unrealized changes in value is simply not acceptable, even though it is the correct measure of income.

The problem is that a realization-based income tax is a contradiction in terms and that contradiction gives rise to complexity, unfairness and distortions. Exhibit A is the treatment of capital gains. Activities as diverse as land speculation, the rental of apartment homes, the purchase of corporate stock and timber operations are allowed—as a result of the fact that we tax realization rather than accruals—to defer tax on income that is earned and accrued until the time when cash is generated from the activity.

In contrast, activities that throw off cash, that is interest on bondholdings rather than appreciation of land holdings, dividends rather than stock appreciation, cash rents rather than appreciation of buildings, and other cash receipts are all disadvantaged by the Tax Code, because in those cases the timing of earnings is the same as the timing of the receipt of cash. Deferral activities, of course, are more attractive than cash activities, since the investor's net worth can grow while tax is paid later.

The resulting diversion of investment to deferral activities results in economic waste, distortion and loss of productivity.

Similarly, with respect to equity, individuals who need immediate cash for whatever reason are taxed more heavily than those who can defer realizing their income or who can borrow or liquidate other assets that have not appreciated. This violates all principles of horizontal equity. The result is, as indicated earlier, that much income is not taxed at all, and income which is taxed by appreciation of assets is taxed in a very arbitrary and capricious way across taxpayers.

The efforts to mute these distortions have produced awesome complexity. We try to answer questions that are really unanswerable. What is a capital asset, what asset sales generate ordinary income, how can excessive borrowing against depreciated assets be prevented, what should be done about capital losses? Or, in general, how can we cope with the full force of human ingenuity bent on converting ordinary income into capital gains?

In certain respects, the tax system attempts to measure accruals, not realizations. But, again, such situations are a source of controversy. Deductions for depreciation are a stand-out example. The depreciation deduction in concept is a measure of the accrued loss in value of an asset over time. But yet when we try to implement such a system, we give rise to rules for depreciation which, again, vary greatly among assets and result in tax advantages and disadvantages across activities and industries that are thoroughly arbitrary.

Another effort to tax accruals rather than realizations concerns imputed interest and expense in situations where the rate of interest in a transaction is either very low or only implicit. We started with original issue discount provisions and now in the 1984 act we have new rules, time value of money calculations, and various procedures to determine interest expense and income in deferred payment and pre-payment situations.

We have moved still further from the actual transaction as the basis for taxation, and as a result we have created the very problems that a transaction-based system is designed to avoid. The new rules are bewildering in their complexity and maybe have limited effectiveness because they are so hard to administer. Why not across-the-board treatment of actual cash transactions as the basis for determining who has received and who has given something of value?

The second defect of conventional tax reform is that it fails to correct distortions of the tax base arising from inflation. And here

I am not talking about bracket creep, which pushes taxpayers up into higher brackets, but really the measurement of taxable income in the first place.

Again, capital gains are illustrative. A dollar of nominal capital appreciation may represent a much smaller real economic gain or even an economic loss, depending on the extent of price inflation while the asset was held. The exclusion of part of the nominal gain is a corrective for this, but it is a corrective which is inaccurate and arbitrary. In any particular case, the 60 percent exclusion may be too large or too small an adjustment.

Inflation distorts the taxation of capital income in other ways as well. It erodes the value of depreciation deductions, it can cause error in measuring the real cost of goods sold out of inventory, and it also causes serious errors in the measurement of interest income and interest expense. During inflation, interest income in part compensates lenders for the loss of real value of principal and should not be taxed.

Similarly, interest expenses represent, in part, a payment of principal and should not be deductible. An accurate calculation of real income for tax purposes would require inflation corrections for all four sources of measurement—capital gains, depreciation, inventories, and interest.

While a completely-based indexing is essential to correct these problems, it is prohibitively complex.

The third defect in the current income tax, and indeed in proposals to broaden the base of the current income tax, is the treatment of corporate source income. Corporate source income is now taxed twice: once at the business entity level and a second time when realized by shareholders, either as dividends or capital gains. Such rules cause income earned by corporations to be taxed more heavily than income in unincorporated business, results in heavier taxation of debt than equity within the corporation and heavier taxation of distributed than retained earnings.

The fourth defect is the taxation of income from capital generally. The annual tax is inherently inefficient and inequitable in the taxation of income on savings. An efficient tax system would not distort choices between consumption and investment, that is between current and future consumption. And an equitable tax system would not impose higher tax burdens on individuals who choose to spend their lifetime resources later in life rather than earlier.

For example, if we had a tax system which imposed a 50 percent tax on taxpayers who preferred to eat apples and an 80 percent tax on those who preferred oranges, we would regard such a system as grossly unfair. But now, in fact, we may tax those taxpayers who choose current consumption at a 50 percent rate, but taxpayers who choose future consumption may be taxed at something equivalent to an 80 percent rate or above on the current consumption that is foregone in generating higher consumption in the future.

We would regard such a tax system as similarly unfair as a system which differentially taxed individuals depending on their consumption choices.

The result of the current system, therefore, is the distortion of saving decisions and discrimination against those who choose to save. Again, the base broadening approaches that have been presented to date do not focus on these issues.

A cash-flow tax would deal with all four of the fundamental criticisms of the annual income tax. The distinction between realizations and accruals is eliminated because all assets are treated in the same way. All problems of unrealized capital gains, original issue discount bonds and imputed interest simply disappear. No particular form of asset is preferred or penalized.

Cash accounting also eliminates the need to index the tax base for inflation. Only outflows of cash for spending or gifts are subject to tax. Neither spending nor gifts needs to be indexed to measure them properly in today's dollars. Problems of indexing depreciation, inventories, capital gains and interest, again, simply vanish.

If cash flow accounting is applied at both the corporate and household levels, the two taxes are automatically integrated, no further mechanism for bringing about such integration is required. The cash-flow tax is also fair and equitable. It does not discriminate between current and future spending; it does not treat consumers who prefer to consume today any differently from those who prefer to consume tomorrow, just as it does not treat any differently consumers who prefer one good to those who prefer another.

None of the base broadening proposals that have been suggested to date deal with all of these inherent deficiencies of the income tax.

I would now like to turn this over to Henry Aaron, who will discuss some of the objections to the cash flow tax and show why they are incorrect.

Mr. AARON. Those who object to taxation have advanced a number of specific objections. I would like to review those objections and indicate why I think each of them either is based on a misunderstanding of the cash flow income tax proposal or is simply logically flawed.

The first objection that is commonly made is that you cannot broaden the base and simultaneously lower tax rates.

That criticism is simply incorrect. All of the major tax reform proposals rest on the proposition that most of the special deductions and credits and exclusions allowed under current law should not be allowed at the individual level. They all rest on the principle that the base of the personal tax should be significantly broadened.

It is true that under the cash flow income tax, a deduction would be allowed for current saving. However, any transfers of wealth by gift or bequests would be included in the base. The result would be a tax base far larger than that under current law that would permit current revenue to be raised and the current distribution of tax burdens to be preserved with much lower tax rates than we now have.

That brings me to the second objection. It is that the cash flow income tax cannot be progressive and that, therefore, it is not fair.

This assertion also is simply false. It is possible to match the existing degree of progressivity under the income tax, to have more progressivity, or to have less, depending on one's taste for progressivity. We tried to match the existing level of progressivity, and it is possible to do so. With much increased percentage exemptions and tax-free levels of expenditure, tax rates of 5 percent on the first $10,000 of outlays on joint returns, 20 percent on the next $30,000, and 32 percent on cash flow over $40,000 per year would yield the same revenue and the same distribution of burdens as current law does.

Because of the inclusion of wealth transfers in the tax base, it would not be possible as it is under current law to make large tax-free wealth transfers, bequests or gifts to future generations.

A third objection is that the cash-flow tax would be unfair to the elderly because typically during retirement years people consume more than they earn.

There are several points to be made here. The first is that the tax-free levels of expenditure would be higher than the current exempt levels of income. In addition, the first tax bracket would be only 5 percent. Also the nonelderly would be able to accumulate assets without paying tax on interest as it accrued. Tax would be payable only when such assets were liquidated. As a result, savers would be able to accumulate far larger savings than they can under current law.

There is an important transitional issue to which I shall return regarding the treatment of assets accumulated out of income on which tax previously had been paid.

The fourth objection is that the cash flow tax is unfair to the young because, like the elderly, they frequently consume more than they earn in the process of establishing households. This is a real issue. We believe there is a real solution. The young, and for that matter all age groups, should be permitted to borrow a certain amount that could be used for consumption without precipitating current tax liability.

In return for that advantage, repayments of principal and interest on those loans would not be deductible. Thus, one would have a choice between two treatments of borrowing. Ordinary borrowing would enter the tax base, and all repayments would then be taxable. Alternatively, borrowing would not enter the tax base and repayments would not be deductible.

The next issue is how the cash-flow income tax would affect homeowners. Here, I think, is is important to distinguish two issues: Tax base that we consider to be most fair, and the kinds of assistance or subsidies we wish to provide to homeowners. The very large tax benefits we provide to homeowners have no logical place in income tax of the present type, in a cash-flow income tax, in a consumption tax, or in a Hall-Rabushka flat tax. It doesn't fit anywhere.

These are extra benefits provided because we want to encourage homeownership. If we want to continue them, we can do so under any one of these frame works. How we treat homeowners is a separate issue from what the base of the tax system should be.

The next objection is that the cash-flow tax would be too complicated for people to understand and too difficult for administrators to enforce. Dave Bradford put it right when he said that for the vast majority of taxpayers who do little saving of a discretionary character, compliance with the cash-flow income tax would be similar to that under the current income tax.

Large simplifications could be achieved for taxpayers who now file complicated returns because of capital transactions of various types.

No tax is self-enforcing in a complicated world. One would have to spend money to deter fraud and abuse under a cash-flow income tax as under any other. But the claim that it is too complex to understand, too complex to administer, is just wrong.

The next issue concerns the concentration of wealth. A number of people have correctly observed that the cash-flow income tax, like the consumption tax, would not impose any tax on accumulations of wealth during the lifetime of the person who accumulated the wealth.

The distinctive characteristic of the cash flow income tax, in contrast to the consumption tax, however, is that such wealth transfers would be taxed when the wealth was transferred to other people.

For that reason, the criticism that is sometimes levied that the cash-flow income tax would promote greater concentration of wealth is just plain wrong. It is wrong also because it presumes that the current tax system poses an effective barrier to the accumulation and transfer of wealth.

It does not, because most large accumulations of wealth grew out of capital gains, which are now untaxed if held until death, and were or will be transferred to others with little tax. The estate and gift taxes are becoming ever more as George Cooper described them in a Brookings study, a "voluntary tax."

On all scores, the cash-flow income tax would stand as a better instrument for preventing large accumulations of wealth over generations than does the current tax system.

The next argument against the cash-flow income tax I find difficult to take very seriously, although it has been advanced seriously by serious people. It is claimed that as a result of the incentives of the tax, consumption would collapse, people would save so much that aggregate economic activity would decline.

I know of no evidence from any responsible economist or business analyst that this kind of an effect would ensue. If savings did increase, we have at our disposal other instruments of economic policy, notably monetary policy, to promote additional aggregate demand.

The last objection to the cash-flow tax is that although it might be a good idea in the abstract if you were introducing a new income tax, you can't get there from here because of the history and institutional arrangements that exist under the personal income tax.

We think this issue is a substantial one, but that the objection is incorrect. The problem boils down to how you treat assets that have been accumulated out of previously taxed income.

It is our view that that problem can be dealt with satisfactorily in an administratively feasible way, one that requires no records in addition to those now required under the income tax, by allowing people to recover without further payment of tax the basis on existing assets.

Avoiding double taxation of existing assets is a problem of moving to the cash-flow income tax. But there is a practical solution.

In closing I would like to allude as to what sounded like an eleventh objection, enunciated by Dan Halperin. He seemed to suggest that it would be a sign of faint heart and lack of courage to give up the struggle to produce a broad based consistent personal income tax.

It is Harvey Galper's contention and my own, and I think one in which some of the other panelists would concur, that Halperin's goal is simply unachievable and that the effort to get to it would make us realize it was undersirable.

Mr. HEFTEL. Thank you very much.

[The prepared statement follows:]

STATEMENT OF HENRY AARON, SENIOR FELLOW, BROOKINGS INSTITUTION AND PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND AND HARVEY GALPER, SENIOR FELLOW, BROOKINGS INSTITUTION [1]

Mr. Chairman and members of this committee, we are pleased to appear here today to discuss our views on reforming the nation's tax structure. Both of us have spent a major portion of our professional lives in analyzing the tax system. We have recently proposed a cash-flow income tax as the fairest, most efficient, and simplest way to collect revenues from individuals and corporations. The Appendix attached to this testimony outlines the elements of this tax. Today, however, we will not discuss specific details of the program, but will explain why we feel such a change is necessary and why no conventional reform of the annual income tax can solve the most serious problems of the current tax structure.

The current tax system is in sad shape in two distinct but related ways. First, it does not come close to raising enough revenue, even at full employment, to pay for the expenditures we are committed to undertake. Second, the tax structure itself is riddled with exemptions, exclusions, credits, and other implicit and explicit preferences that distort savings, consumption, and investment; befuddle taxpayers, and make lawyers and tax-shelter syndicators rich; and produce gross unfairness. These problems are distinct, because it is possible to increase revenue without fixing the structural defects, and correcting the structural defects need not raise additional revenues. But they are closely related because simply increasing tax rates aggravates the adverse effects of a distorted tax base.

As far as the congressional calendar is concerned, the two issues are competitive as well. Structural tax reform takes a lot of time. Congress should not be rushed into making major changes in the tax system without adequate attention to how these changes are to be implemented, the particular groups affected, and a thorough and systematic review of various alternatives. A rushed approach will spawn a pick-and-patch reform package that creates new distortions, even as it closes old ones. In contrast, the need for revenues is immediate and urgent. A deficit of $200 billion adds $20 billion a year to interest payments and to next year's deficit every year. Action to reduce deficits of this magnitude should be taken as quickly as possible.

Thus, with respect to tax reform, we advocate a two-track strategy. First, revenues should be raised promptly in a way that does not preclude long-run reform. On a parallel track, the tax-writing committees should continue evaluating options for structural tax change. Desirable changes can be made only after thoughtful and considered deliberations. The immediate need for additional revenues should not lead to the adoption of revenue-raising measures that do not make sense as part of an on-going review system.

There may not be many short-run revenue raisers that can be put into place quickly and that would not preclude desirable, longer-term reform. For this reason, we advocate, to the extent necessary, a temporary surtax to raise revenues in the short term. It should be the specific objective of structural tax reform to broaden the base sufficiently to repeal the temporary deficit-reducing surtax.

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[1] The views expressed in this statement do not necessarily reflect those of Brookings staff members or the staff members of the University of Maryland or the officers and trustees of the Brookings Institution.

We shall divide the remainder of our remarks into three parts. First, we shall explain why all reforms of the annual income tax fail in important respects to achieve the goals of tax reform: fairness, simplification, and reduction of distortions of economic choices. Second, we indicate why the cash-flow income tax we propose does far better on those grounds. Third, we explain why the commonly-stated objections to the cash-flow income tax are, to put it bluntly, dead wrong.

PROBLEMS WITH CONVENTIONAL INCOME-TAX REFORM

Income tax reformers for years have been seeking to broaden the tax base by eliminating or reducing itemized deductions, by repealing exclusions, and by eliminating tax credits. This strategy has not been a smash hit at the political box office. If it had succeeded, the tax system would not be in the scandalous state we now observe. But even in that event, the income tax would have important defects that would cause inequity, inefficiency, and complexity.

In our view, the failure of such traditional approaches in the past is only partly due to the political compromises that inevitably are made in the enactment of tax legislation. At least as important are the inherent defects of the income tax itself. Even a comprehensive income tax base would have four serious shortcomings. We emphasize these shortcomings not as a matter of academic interest or to urge a quixotic search for a perfect search. We emphasize them because they are root causes of dissatisfaction with the income tax and because none of the proposals for broadening the base of the annual income tax begins to deal with them in an adequate way.

ACCRUALS VERSUS REALIZATIONS

The first defect is that the income-tax inevitably must be transactions-based and therefore is essentially a tax on income as realized, not on income as accrued or earned. We do not support an accrual-based system. As a practical matter, trying to tax unrealized changes in values is simply not acceptable. But it is the correct measure of income.

The problem is that a realization-based income-tax is a contradiction in terms, and this contradiction shows up in complexity, unfairness, and distortions. Examples abound. Exhibit A is the treatment of capital gains. Inflation aside (more on that later), taxing gains on a realization basis allows income in the form of appreciation of assets to go untaxed until the assets are sold. Activities as diverse as land speculation, the rental of apartment houses, purchases of corporate stock, and timber operations are allowed as a result to defer tax on income that is earned and accrued until the cash is generated from the activity. In contrast, activities that throw off cash—interest on bond holdings (rather than appreciation of land holdings), dividends (rather than stock appreciation), cash rents (rather than appreciation of buildings), and cash crops (rather than timber grown)—all are disadvantaged by the tax code because in those cases the timing of earnings is the same as the timing of the receipt of cash.

Deferral activities are more attractive than cash activities since the investor's net worth can grow while tax is paid later. The resulting diversion of investment to deferral activities from cash activities distorts the economy and reduces productivity.

Similarly, individuals who need immediate cash for whatever reason are taxed more heavily than those who can defer realizing their income (or who can borrow or liquidate other assets that have not appreciated), violating all principles of horizontal equity.

The efforts to mute these distortions and inequities have produced awesome complexity. We try to answer unanswerable questions: what is a capital asset? What asset sales generate ordinary income? How can excessive borrowing against appreciated assets be prevented? What should be done about capital losses? In more general terms: how can we cope with the full force of human ingenuity bent on converting ordinary income into capital-gains?

Admittedly, part of this problem results from another artificial distinction, that between long-and short-term capital gains (although again one must not forget the problem of inflation). But even if all capital gains were treated as ordinary income, deferral remains a powerful incentive. For example, at a 50% tax rate and with a 12% rate-of-return, deferral of tax for 20 years is equivalent to exemption of almost one-half of the return.

In certain well-accepted respects, the tax system attempts to measure accruals not realizations. Such situations are always a source of controversy. Deduction for depreciation are a standout example. The depreciation deduction, in concept, is a measure of the accrued loss in value of an asset over time.

Despite the growing availability of information that could be used to calculate true economic depreciation, allowable depreciation deductions differ greatly and by widely varying amounts from true economic depreciation. As a result, some activities are favored relative to others. The worst culprit on this score in recent years was ERTA, which spewed out relative tax advantages and disadvantages across industries in a throughly arbitrary fashion. A cash-accounting approach—where the cost of the asset is deducted when purchased—would again be preferable on grounds of neutrality, simplicity, and fairness across taxpayers.

Another effort to base tax on accruals rather than realizations concerns imputed accrued interest and expense in situations where the rate of interest in a transaction is only implicit. From the original issue discount (OID) provisions in 1969, the code has developed to the 1984 Act, replete with new OID rules, time-value of money calculations, and various procedures to determine interest expense and income in deferred payment and prepayment situations.

Although such guideline rules are intended to prevent important abuses, the 1984 Act, by moving still further from actual transactions as the basis for taxation, creates the very problems that a transaction-based system is supposed to avoid. The new rules are bewildering in their complexity and may be of limited effectiveness because they are so hard to administer. Some nonplussed observes of this scene recommend that we scrap this entire apparatus of imputed interest in favor of actual cash transactions as the basis for determining who has received and who has given something of value.

INFLATION

The second defect of conventional tax reform is that it fails to correct distortions of the tax base arising from inflation. This problem is quite distinct from, and far more important than, bracket-creep, the tendency of inflation to push taxpayers into higher marginal tax rates, even if their real incomes do not change. The more serious problem is the measurement of taxable income in the first place.

Again capital gains are illustrative. One reason commonly advanced for the exclusion of 60 percent of long-term capital gains is that full taxation of capital gains may be grossly excessive during periods of inflation. A dollar of nominal of capital appreciation may represent a much smaller real economic gain, or even an economic loss, depending on the extent of price inflation while the asset was held. If prices have doubled, the taxpayer who sells an asset for twice its basis has realized no real income.

The exclusion of part of the nominal gain as a corrective is inaccurate and arbitrary in the extreme. In any particular case, the 60% exclusion may be too large or too small an adjustment.

Inflation distorts the taxation of capital income in other ways as well. It erodes the value of depreciation deductions that allow recovery of only the historical cost of a depreciating asset. It can cause errors in the real cost of goods sold out of inentory when there is a significant lag between the time goods were purchased for inventory and their subsequent sale. Both LIFO and FIFO have serious problems in this respect.

Inflation also causes serious errors in the measurement of interest income and expense. During inflation interest income in part compensates lenders for the loss of real value of principal and should not be taxed. Similarly, interest expenses represent in part a payment of principal and should not be deductible.

An accurate calculation of real income for tax purposes would require inflation corrections for all four sources of mismeasurement—capital gains, depreciation, inventories, and interest. A piecemeal approach would not be satisfactory. For example, if only capital gains were indexed, it would become even more advantageous to borrow funds for the purpose of holding appreciating assets. All nominal interest payments (including what is in reality repayments of principal) would be deductible even though only the real capital gain would be taxable. Furthermore, since the rate of inflation is highly variable from year to year, any ad hoc adjustments are likely to be quite inaccurate in offsetting the inflationary taxation of capital income over time.

The lack of tax base indexing during inflation thus causes inequity and inefficiency and promotes complex transactions either to escape or to capitalize on its effects. Taxpayers in the same economic circumstances will suffer widely varying losses or gains depending on the kinds of assets and liabilities they may hold. Inflation distorts investment decisions in an unindexed system because inflation changes tax burdens differentially across investments and activities and because of the uncertainty engendered when taxes can change unpredictably and capriciously. While complete tax base indexing is essential to correct these problems, it is prohibitively complex. Adjustments of depreciation, inventories, and many capital gains, are possible with some increase in administrative burdens. But indexation of interest payments and receipts on such items as home mortgages, zero coupon bonds, and bank accounts would simply not be feasible administratively.

Two other issues left unresolved by all base-broadening tax reforms now before Congress relate to the question of how income from capital should be taxed. Even if accruals and inflation posed no special difficulties, these problems would demand attention.

CORPORATE INCOME

Corporate source income is now taxed twice—once at the business entity level and a second time when realized by shareholders either as dividends or as capital gains from sale of appreciated stocks. Such rules cause income earned by corporations to be taxed more heavily than income earned by unincorporated business. It also results in heavier taxation of debt than of equity within the corporation, and in heavier taxation of distributed than retained earnings. To meet these problems, virtually all of our major trading partners have coordinated personal and corporation income taxes in some way. However, none of the traditional base-broadening proposals have focused on this question.

SAVING AND INVESTMENT

The annual income tax is inherently inefficient and inequitable in the taxation of income on savings. An efficient tax system would not distort choices between consumption and investment (that is, between current and future consumption. An equitable tax system would not impose higher tax burdens on individuals who chose to spend their lifetime resources later in life rather than earlier.

The current income tax and proposed revisions fail on both counts. The income tax reduces the amount of future consumption that can be financed out of current earnings by a far larger proportion than it reduces the amount of current consumption that can be financed from the same earnings. The result is a distortion of saving decisions and discrimination against those who choose to save.

Although consideration of these four fundamental problems is critical to the evaluation of the current annual income tax, virtually no attention has been given to them in the traditional base-broadening proposals for tax reform.

CASH-FLOW ACCOUNTING

A cash-flow income tax would deal with all four of the fundamental criticisms of the annual income tax. The distinction between realization and accruals is eliminated because all assets are treated in the same way. For example, both quarterly interest on savings accounts and appreciation of corporate stocks would be taxed only when the asset is converted to cash and the proceeds are consumed or transferred to others by gift or bequest. Selling one stock and buying another would be treated the same as letting the first stock run. Only expenditure of the proceeds on consumption or on transfers to others would generate tax liability. In all cases, the net outflow of cash is the taxable event. All problems of unrealized capital gains, original issue discount bonds, and imputed interest simply disappear. No particular form of asset is preferred or penalized.

Cash accounting also eliminates the need to index the tax base for inflation. Under the cash-flow approach, only outflows of cash for either spending or gifts are subject to tax. Neither spending nor gifts need to be indexed to measure them properly in today's dollars. Another way of saying the same thing is that under cash accounting the cost of real or financial assets is deductible when the asset is purchased. Since the cost is fully recovered at that time, there are no further costs to be recovered at a later time when prices may be higher. Problems of indexing depreciation, inventories, capital gains, and interest simply vanish.

If cash-flow accounting is applied at both the corporate and household levels, the two taxes are automatically integrated. The corporate tax would not impose a separate wedge between the before-tax return available to the corporation on its investments and the after-tax return available to the saver who finances those investments.

The cash-flow income tax is fair and equitable. It does not discriminate between current spending and future spending. It does not treat consumers who prefer to consume tomorrow any differently from those who consume today, just as it does not treat any differently consumers who prefer one good to those who prefer another. (One of the philosophical mysteries of our time is why taxes that favor one kind of consumption over another are universally condemned as arbitrary and unfair, while an income tax that favors present over future consumption is regarded as altogether fitting and proper.) The cash-flow income tax, described in the Appendix, is free of both kinds of discrimination.

FALSE, WRONG, AND OTHERWISE MISGUIDED REASONS FOR OPPOSING THE CASH-FLOW TAX

Despite its virtues, the cash-flow approach to taxation has been subject to a number of criticisms. In this section, we show that these criticisms at worst rest on a misrepresentation of the cash-flow income tax or on faulty logic and at best are just indicators of problems that can be readily solved under cash-flow accounting.

Wrong reason No. 1.—It is not possible to broaden the tax base and thereby lower tax rates under the cash-flow tax.

Response.—This criticism is simply incorrect. It is possible to broaden the base of such a tax relative to the current annual income tax simply because the tax base is now so shot full of holes. For example, including a higher portion of fringe benefits can be included under both the cash-flow income tax base and a broadened annual income tax base. Itemized deductions can be reduced under both taxes, and unnecessary and inefficient credits can be eliminated.

The cash-flow income tax does allow deductions for net savings, but it includes transfers of wealth during life and at dealth in the tax base. As a result, the revenue yield and distribution of tax burdens under the current annual income tax can be generated from a broad cash-flow tax base with increased personal exemptions and zero-bracket amounts and with a top marginal tax rate of 32%, a substantial reduction below the 50% top rate under current law.

Wrong reason No. 2.—The cash-flow tax cannot be progressive and therefore is unfair.

Response.—This assertion too is simply false. The degree of progressivity in the current system can be matched (or exceeded) under the cash-flow income tax. After a generous exemption for tax-free levels of cash flow, one could match current progressivity with rate structure of 5% on the first $10,000 of cash flow for a joint return, 20% on the next $30,000, and 32% on cash flow over $40,000 per year.

In addition, transfers of wealth would be included in the tax base, so that households could not avoid tax by refraining from consumption during their lifetime and transfering large amounts of wealth to children and grandchildren tax-free. Finally, the cash-flow tax adopts a lifetime perspective on the issue of fairness, rather than a one-year perspective. Annual income is a poor measure of long-term ability to pay.

Wrong reason No. 3.—The cash-flow tax is unfair to the elderly who have to consume more than their current income.

Response.—There are several parts to the response to this criticism. For the elderly poor, the increased tax-free levels of consumption along with the low 5% rate on the first slice of cash flow ($10,000 for a joint return), allows for a much higher level of expenditure than under current law with little or no tax. Those elderly who are drawing down pension funds, IRA accounts, or other tax-free accumulations of assets are already close to being on a cash-flow income tax. For them there would be little change.

With respect to the higher-income elderly, the opportunities for increased earnings on assets acumulated during their life more than offset the tax that will be due when those assets are subsequently drawn down. As a result, the after-tax position of the elderly will be improved, even if they are paying higher taxes during their retirement years than they would pay under current law.

In addition to these important advantages to retirement saving, we favor allowing the elderly to consume or transfer without further tax an amount equal to the basis of assets in their possession when the cash-flow income tax initially takes effect (see wrong reason No. 10 below).

Wrong reason No. 4.—The cash-flow tax is unfair to the young who are just starting out in life.

Response.—The answer to this objection is similar to that given for the elderly. First, the higher levels of tax-free cash flow and the low first-bracket rates under the cash-flow tax would allow higher levels of tax-free consumption than current law. A family of four, for example, would pay no tax on the first $11,250 of cash flow and only 5% on the next $10,000.

In addition, the cash-flow plan can reduce current tax liability for consumers by allowing them to borrow up to some amount, say $20,000, without including the proceeds in their tax base. In return, they would be denied deductibility for repayments of principal and interest on this borrowing. In this way, tax on consumption can be deferred to the future with interest.

Wrong reason No. 5.—The cash-flow is unfair to homeowners.

Response.—The current tax treatment of owner-occupied housing is more generous than would be allowed under a pure annual income tax, consumption tax, or cash-flow income tax. Concessions to homeowners can be grafted on to any of these taxes. Whether we should have a cash-flow income tax or an annual income tax is entirely separate from the question of whether homeowners should have such concessions. If it were felt desirable to treat an owner-occupied home the same as all other assets, this could certainly be accomplished under the cash-flow income tax. On the other hand, if it were felt desirable to maintain some additional benefits for homeownership, the cash-flow income tax could accommodate such preferences just as does the current income tax.

Wrong reason No. 6.—The cash-flow tax is too hard for taxpayers to understand or for administrators to enforce.

Response.—For most taxpayers the cash-flow tax would involve little if any changes from their current system of accounting. Taxpayers who spend pretty much what they earn would find their tax calculation very straightforward. Taxpayers apparently find no great difficulty in handling IRAs or pension plans. The cash-flow tax merely generalizes pension and IRA treatment to all saving. For taxpayers with complex and sophisticated transactions, involving capital gains, depreciation, and income from real and financial investments, the cash-flow income tax would be a simplification rather than a source of complexity.

In a complex world no tax can be fully self-enforcing. Any tax system will require resources to be devoted to administration to prevent abuse and fraud. In view of the simplifications involved for many financial transactions, however, we believe the cash-flow tax to be more likely to lead to higher levels of taxpayer compliance than does current law.

Wrong reason No. 7.—The cash-flow income tax would permit greater concentration of wealth than is possible under current law.

Response.—This criticism is erroneous on two grounds. It incorrectly presumes that current law is effective in reducing concentrations of wealth; and it incorrectly presumes that the cash-flow tax would not retard perpetuation of wealth concentration.

The combination of annual income and estate taxes has had little effect on the intergenerational transfer of accumulated wealth. Most large accumulations of wealth consist of accrued capital gains which are never taxed if held until death. The estate tax is so riddled with legal avenues of avoidance that it has been labeled "the voluntary tax." Large additional sums can be transferred free of tax during life. The present tax system is simply ineffectual in preventing the perpetuation of large fortunes.

The cash-flow income tax would encourage saving and accumulation of wealth during the taxpayer's life. But it would be far more effective in preventing survival of concentrated fortunes across generations. It would allow only limited tax-free transfers through gift or bequest. All other transfers would be subject to tax. Furthermore, consumption by heirs out of inherited wealth would be subject to cash-flow income tax, in contrast to the free-ride under current law. The stiffer rules on wealth transfers are a fair and appropriate quid pro quo for reduced taxation on unconsumed income during life.

Wrong reason No. 8.—People will not consume under the cash-flow tax and as a result the entire economy will suffer.

Response.—This is a question of how responsive savings will be to the new tax structure and of whether any such responses can be offset by other policies, so as to maintain high levels of employment and economic activity. Experience with existing tax provisions suggests that large increases in saving are unlikely to occur under the cash-flow income tax. Indirect evidence of this is the fact that many taxpayers have not taken full advantage of the opportunities available to them for investing in Individual Retirement Accounts, even though, in many cases, no new saving has to be undertaken in order to open up such accounts. The proliferation of private pension plans has led to no increase in household saving.

If consumption were to fall, however, other government policies could easily offset this effect. Monetary policy could be eased, thereby stimulating further investment to match the increase in saving. It is worth noting that some people also hold that the U.S. economy would be strengthened if capital accumulation could be increased. The argument can't run both ways.

Wrong Reason No. 9.—The cash-flow tax cannot be coordinated easily with the tax systems of our trading partners.

Response.—Steps to coordinate the cash-flow income tax with the tax systems of other countries would certainly be necessary. As under current law, the key to international tax harmonization is making sure that international transactions are not taxed more than once and are not differently advantaged relative to domestic transactions. Although appropriate arrangements, including the re-working of tax treaties, may have to be negotiated with our trading partners, such measures are quite feasible.

Wrong Reason No. 10.—The cash-flow income tax may be a fine idea, but you cannot get there from here.

Response.—This seems to be the objection of last resort on the part of those opposing the cash-flow income tax. Even if they recognize that it would be a superior tax system once in operation, they state that any transition to the cash-flow income tax would inevitably be disruptive, unfair, and unworkable.

Transition problems do indeed exist under the cash-flow tax. This must be acknowledged. However, many of the same transition problems arise under base-broadening in the context of the current income tax. In both cases the relative taxation of different assets will be changed generating gains and losses across taxpayers unless specific transition rules are worked out. Thus, many of the transition problems in moving to a cash-flow income tax are identical to those in any fundamental tax reform.

But some other transition problems are unique to the cash-flow tax. This is the problem of ensuring that assets that were acquired under the previous tax regime are not taxed again when drawn down for consumption under the cash-flow regime. This issue would be of particular concern to people near retirement who now expect to be able to use their assets to sustain their standard of living without paying further tax. We have developed transition rules to solve this problem. The key is to permit cost recovery of assets outstanding at the time of the new regime while, at the same time, maintaining the revenue base from the government's point of view. The transition issue is an important one, but it is also a manageable one.

CONCLUSION

The cash-flow income tax deserves serious consideration in next year's tax debate. Indeed, as we have indicated by reference to Individual Retirement Accounts and employer pension plans the current annual income tax has many cash-flow elements already. But our first message is also our last. Please do not let immediate revenue needs impel you to piecemeal action that does not address the fundamental deficiencies of our current tax structure.

APPENDIX

THE CASH-FLOW INCOME TAX

The base of a cash-flow income tax would be comprehensive receipts less saving. The tax on saving would be deferred until the savings were consumed or transferred to others by gift or bequest. The proceeds of consumption loans will be included in the tax base. End-of-lifetime wealth representing unexercised potential consumption of the taxpayer would be included in the tax base.

Receipts would include all wages and salaries, rent, interest, profits, dividends, transfer payments, gifts received, and inheritances. Savings would be defined as all payments into certain "qualified accounts," including all financial assets (stocks, bonds, and other securities), all accounts in banks and other depository institutions, and the purchase of real estate (except owner-occupied housing).

Just as saving is deducted from cash receipts, withdrawals from qualified accounts (or dissaving) would be added to the tax base. Similarly, the proceeds of loans would be included in the tax base, and loan repayments, including both principal and interest, would be deductible in reaching the tax base.

Inheritance and gifts received would be counted as a receipt, but if they were not consumed, they would be exactly offset by an increase in savings. Gifts and bequests made would be treated as consumption in the year during which they occur, subject to an average provision if the amounts transferred were large relative to annual income.

It would be desirable to award each person a lifetime exemption for a certain amount of gifts or bequests to permit tax-free transfers, for example between parents or children at time of need. But very large exemptions would result in unequal taxes on people with similar lifetime spending capacities. A lifetime exemption of $100,000 per person ($200,000 per couple) would permit most families to exclude all gifts and bequests from tax. But since most wealth transferred between generations is concentrated in large estates, such an exemption would not materially erode the principle that lifetime income should be taxed in full.

Personal exemptions would be allowed as under the present personal income tax, although the exact amount should be modified. We propose as a minimum standard that no tax be imposed on people whose cash flow equals current poverty thresholds. Based on estimates for 1984, tax-free levels of cash flow would be set at $5,000 for a single person, $8,250 for couples, and $1,500 for each additional dependent. In addition, some account should be taken of the fact that one-earner families are better off than two-earner families with the same income. Two-earner families lose in-home services provided by the nonearning spouse in a one-earner household and may incur money costs for child care and other household services. Accordingly, we recommend that the deduction of 10 percent of the earnings of the spouse with lesser earnings, up to some maximum earnings level ($30,000 per year under current law), be continued. Similarly, a credit for low-earners, like the earned-income credit now allowed certain workers with low earnings, might also be provided.

Tax rates would be progressive under the cash-flow tax to approximate the current distribution of tax burdens. For joint returns, annual cash flow would be taxed as follows: 5 percent tax on the first $10,000 of taxable outlays, 20 percent on the next $30,000, and 32 percent on taxable outlays over $40,000 per year. For single taxpayers, the same rates would apply to taxable expenditure brackets of less than $5,000, $5.000 to $40,000, and over $40,000.

Personal deductions or credits other than those already noted, would be severely limited. For defining ability to pay, deductions could be allowed for extraordinary medical expenses or for casualty losses on assets which have not been expensed. For social policy purposes, a tax credit could be provided for charitable contributions.

The corporation tax would consist of two parts. The first would be a tax on cash flow. The corporation tax base would include total receipts of the corporation from all sources other than the sale of stock, less all business expenses, including investment in the year paid for. Deductions for business expenditures on consumption-type items for the benefit of employees or owners would be denied. The business tax base would include the proceeds from borrowing. Corporations would be entitled to deduct all debt service payments, but no deductions would be permitted for dividends or any other cash distribution to stockholders. If firms borrowed to finance investment, no tax would result in the year the investment was made; the expenditure on the investment would just offset the proceeds from the loan. If earnings on the investment differed from the repayment of debt, corporate cash flow and tax liabilities would be affected.

The second element of the tax on corporation would be a withholding tax on all distributions from corporations to foreigners. This tax would apply to devidends, interest, rents, royalties, or to any other cash distribution. But this withholding tax would be final for taxpayers not subject to US. taxation.

The expensing of new corporate investment under the cash-flow tax, in effect, makes the government a participant in returns that differ from the government borrowing rate. The business tax deduction for investments at the time of purchase causes an intial reduction of government revenues. The government recovers this "investment" by collecting tax on the return to the investment. The government comes out even when the flow of such taxes, discounted at the government's borrowing rate, just equals the loss of revenue from the initial deduction. The tax is positive, in present value terms, to the extent that the business rate of return exceeds the government's borrowing rate. Some part of the return above the government's borrowing rate represents compensation to investors for the riskiness of some corporate investments. But part may represent the extra return to firms that enjoy particularly favorable market positions. Taxation of "rents" on these monopolistic advantages is an improvement in the efficiency of the tax system.

Mr. HEFTEL. Mr. Goode.

STATEMENT OF RICHARD GOODE, GUEST SCHOLAR, THE BROOKINGS INSTITUTION AND PROFESSORIAL LECTURER, SCHOOL OF ADVANCED INTERNATIONAL STUDIES, JOHNS HOPKINS UNIVERSITY

Mr. GOODE. Thank you, Mr. Chairman. I will try to be very brief, because the hour is late. I will summarize what I have written in my statement and perhaps comment on some of the other remarks that have been made.

I would like to talk particularly about the individual income tax with only incidental reference to the corporation income tax. When the Ways and Means Committee in 1913 reported the first income tax bill under the 16th amendment, the committee called the income tax the fairest and cheapest tax. It pointed out that it would have an elastic yield.

The committee was certainly right about the elastic yield. As we know, the income tax has become a mass tax and our most productive single revenue source since World War II. It has in my judgment very important attractions in terms of its relation to ability to pay, on which I will try to elaborate a little later, and its adjustment to the personal circumstances of taxpayers, and its adaptability to progressive rates.

For a long time there was very wide acceptance of the idea that the income tax was the best tax. I believe that idea has been undergoing change—as you have heard already from other witnesses.

It is very interesting to compare two public opinion polls which were conducted for the Advisory Commission on Intergovernmental Relations—the poll taken in 1972 found that a plurality of the respondents thought that the income tax was the fairest tax of all of those used by the Federal, State, and local governments.

But in 1983, a plurality considered the individual income tax the least fair tax of all of those used in our country. Now, why that change? I think we ought to face up to the reasons for the change—and persons like myself who are supporters of the income tax idea, particularly ought to ask ourselves why the change.

I identify in my written testimony some four reasons for the change, and I will refer to them only very briefly now.

One is a point which has been repeatedly brought to the attention of the committee. It is the proliferation of tax preferences, tax expenditures, if you want to call them that, which were designed or intended to relieve hardship or encourage particular kinds of activities which would be desirable on some basis.

As you know there are more than 100 of these provisions, and I think many people regard many of them as unjustified, unfair, and benefiting other people, perhaps benefiting the rich mainly. Economists have their complaints about them, too.

The second reason that I see for the decline in the standing of the income tax is that there is a belief that there is a lot of evasion and avoidance.

It is very hard to nail that down. We don't know precisely how much evasion there is. But it is a subject of concern, I think, that the audit coverage of individual tax returns has declined from 2.6 percent of all returns in 1976 to an estimated 1.3 percent in this year. Some of the estimates that the Internal Revenue Service has produced for tax evasion, which may be subject to dispute, nevertheless are quite disturbing.

A third reason that I note is the interaction of the individual income tax with inflation. We know about bracket creep. We know that the measurement of income is distorted to some extent by inflation.

In a period of inflation, people find when they get an increase in money income it doesn't buy what they expected. Who is to blame?

The income tax and the Government are visible targets and people tend to blame the tax for some of their troubles.

A fourth reason is that the income tax attracts the opposition of those people who have been led to believe Americans are overtaxed.

The individual income tax, being a direct tax and a visible tax, it is an easy target for people who feel they are over-taxed in general—although our tax ratio is lower than in most other industrial countries, all other except Japan, and in some years, Switzerland.

And the tax total is a good deal lower than the amount of expenditure we would like to have.

For a long time the tax reform prescription that has been advanced, the one the committee has heard already this morning, has been: broaden the base of the income tax by eliminating or restricting unjustifiable exclusions and deductions, and lower nominal rates.

I still accept that prescription. I don't intend to discuss the details unless the committee should so desire. I understand that the purpose of these hearings is to discuss broad principles.

I think that a suitable reform in the direction of broadening the base and reducing nominal rates should be accompanied by stricter enforcement measures, by more appropriations for audit work, and by extension of withholding of tax.

If we want to make some adjustments for inflation, it certainly would be technically feasible to do a great deal. At the cost of some complication we can index the brackets and the exemptions.

We can index the basis for capital gains and losses, we can adjust capital cost recovery provisions. It is admittedly not feasible in my judgment to make a perfect adjustment for the problem of the interaction between inflation and interest income and interest payments.

But it seems to me there is a much deeper question involved here. How far do we really think we can go and should go in trying to make people more comfortable with inflation?

Full indexing of everything in the economy is not imaginable because it would imply that just by a technical device we could negate all the powerful forces that bring about inflation. So the question is what part of the economy are we going to index.

To what extent do we want to index the income tax? I shall not try to give an answer to that, except to reassert that we could do a great deal if Congress really felt that it was essential.

But we should recognize, I believe, that inflation is an evidence of political and economic pathology which cannot really be remedied by little bites along the edge of that sort.

What about the alternatives to a broad-based income tax that are being proposed? You have heard about them today. I think it is very interesting that the other members of the panel call their proposals income taxes, though really they are not income taxes in the traditional sense.

I had a good deal of difficulty I am frank to say with Professor Hall and Mr. Rabushka's terminology. Part of the time they said they were taxing all income, but they also said that they were honoring the consumption principle in their tax.

I think their tax is a consumption tax basically—what I call a truncated expenditure tax. It is very easy to explain that, if you stop to think about it.

Under the Hall-Rabushka proposal, if one spends $100 for a real investment asset, one saves $19 of tax immediately, and the net cost is $81.

Then if one earns $1 of return on that asset, one pays 19 cents of tax and has 81 cents left. Eighty-one cents bears the same relation to the $81 of cost of the capital asset that you would have in a tax-free environment.

I suggest that it is not the case that that kind of measure taxes all income. As a matter of fact, it doesn't tax investment income at all.

Perhaps that would be one of the merits that some would see in it. But I think we ought to recognize that substantially investment income is not taxed.

It is true that the Aaron and Galper proposal is different, quite a bit different. They propose, however, that during lifetime everyone would be taxed only on consumption expenditures. When a person disposes of assets by gift or bequest Aaron and Galper intend to treat that disposal as if it were a consumption expenditure.

May I say a few words about why I think the income tax is better than these other measures. I don't defend all provisions of the existing income tax. Of course, I would like to see the base broadened and the rates adjusted.

The first thing I could mention is that we have had 70 years of experience with the income tax and no experience with these other measures. During 70 years we have had scores of committee reports on income tax problems, we have had hundreds of judicial decisions, we have had thousands of articles in the economic journals and law reviews.

And we have learned a good deal about the income tax. That is not unimportant. The income tax is used in other countries, too. We can learn from their experience, and we can relate our system to those of other countries that apply the income tax.

But more important, the second reason for preferring the income tax is that in my judgment income is a better measure of ability to pay than consumption is.

Income is a broad measure of one's command over economic resources. Saving is a private decision.

Saving does not detract from one's ability to contribute to the support of the commonwealth in my view. I do not accept the proposition—and this may be a dispute about words, but words are very important in this connection—advanced most strongly by Professor Bradford this morning, but also advanced by Mr. Aaron, I believe, a moment ago, and Mr. Galper, that the income tax penalizes saving. The income tax doesn't penalize saving. The income tax doesn't apply to savings per se at all.

What the income tax does is tax persons who gain some income, either by working or by investing or lending their money. If I save $100 and put it in my mattress, nothing happens under the income tax to affect that decision at all. I can take that $100 out of the mattress and spend it any time I like.

But if I expect to increase my income by investing that $100 and getting a return on it, the income tax will apply. All this may be a matter of terminology. But it is not unimportant.

I cannot go along with Aaron and Galper on the argument that it is incorrect to say that the consumption tax would apply taxes at an awkward time in the life cycle, at an awkward time in one's life.

I do believe that is important. I would just note that expenditures are high relative to income for young families, for the elderly, and for anyone who has a poor year because of unemployment, bad business or what not. To tax people relatively heavily at those times is to go contrary to the principle of convenience.

I know that many economists like to look at a lifetime perspective on income, and like to equate income this year with income or expenditure 40 years from now by applying a proper rate of discount.

But I don't really believe that is a realistic way to look at taxpayers' convenience. And I think it totally overlooks the fact that conditions change year by year, tax laws change, tax rates change, economic conditions change, interest rates change.

So it is very difficult to know how the lifetime perspective would really work.

Another reason why I think income taxation is better than the alternative is that it does not allow the untaxed accumulation of personal wealth. Hall and Rabushka and the straight expenditure tax advocates are apparently quite unconcerned about that.

There is no tax so long as one accumulates wealth and doesn't consume it.

Aaron and Galper are concerned. They say they will tax all of that wealth when it is given away or bequeathed—let the Government just wait along with the heirs—and in due course it will be able to take its part.

I think that is a lot better than the expenditure tax proposals or the Hall-Rabushka proposal that don't tax wealth accumulation. But I think there is a still better way of doing it, if we are concerned about this problem, and if Congress is inclined to address it. That is to have constructive realization of capital gains at bequest or on gifts, and to combine that with an appropriate transfer tax.

But I have to say that the recent trend of legislation is not very encouraging, either for my proposal or the proposal of Aaron and Galper, and one wonders if they would really press their proposal if they were not optimistic about getting a much stronger treatment of transfers under their tax than exists today.

I will try to hasten on and say something quite contrary to an assertion that is widely made. I am not convinced at all that the cash flow tax or expenditure tax is simpler than the income tax. All those persons who can file short form income tax returns would have to supply a good deal more information than they have to supply now. They would have to show their transactions in assets and liabilities, something totally different, something very difficult for them and for other people as well. Complete accounting of all sorts of transactions would be needed because errors and omissions would affect the tax base dollar-for-dollar because the tax base is a residual.

I think we have to be a litle cautious about estimates based on a residual. Under the income tax if I fail to report a sale of a capital asset, I may escape the tax on my capital gain, but under the system of expenditure taxation, I would escape tax on the full proceeds that I realized.

Now, Hall and Rabushka's proposal is simpler. I agree. However, I would say I don't think it is quite as simple as they maintain. It is always possible to summarize the last stages of the computation of a tax on a few lines.

But what you have to ask is how do you arrive at those lines. And some problems would exist. There are some anomalies, I think, under this tax. One wonders what they do about interest receipts on Government bonds. They apparently don't worry about income received from abroad, or capital gains. And, of course, from my point of view, and admittedly this is a matter of opinion, the absence of graduation is a great defect.

It is true that capital consumption allowances are easier under a cash flow tax than under an economic income tax, but they are not any simpler than they are under the present accelerated cost recovery system, which is an arbitrary system.

The social saving that might be realized because of simplification would be smaller than any saving on Federal income tax accounting, because we would still have to do conventional accounting for State and local taxes, for foreign income taxes, and for many other purposes.

The fact is there are only two countries in the world that have tried an expenditure tax. They are India and Sri Lanka. In both cases it was a dismal failure.

I think advocates of these other taxes like to assume that somehow all of the tax preferences that we have now would disappear if we simply adopted a cash flow tax or an expenditure tax.

I see no reason to believe that tax preferences would be more easily eliminated by going over to one of the other taxes than would be possible now. We, I think, all recognize that there are underlying forces that support the provisions for home owners, for charitable contributions, for medical expenditures, for fringe benefits. These forces would not disappear automatically under an alternative tax.

I have already said something about inflation. I think it is true that the cash flow tax does deal more easily with inflation than an income tax can. But we could do a good deal under the income tax at the cost of some complication.

As regards the effect on personal saving, I am inclined to believe, although it is hard to prove definitively, that there would be some encouragement to saving under a consumption tax or an expenditure tax.

But I think that is almost irrelevant for public policy in the foreseeable future, because the biggest influence that this committee can have on saving is to do something about the budget deficit. The deficit is a huge negative item in saving or a use of private saving, which will dominate the picture for the foreseeable future.

In conclusion, I would just like to reiterate that I think the individual income tax is still our best tax, but I agree that we need to overhaul it, and we need to do that urgently. We need to do that by trying to broaden the base, by eliminating or restricting some of the exclusions and deductions that are not justifiable in present circumstances. Nominal rates could then be reduced.

But I think rates should not be reduced enough to offset the full effect of base broadening. I think tax reform would be the best way of obtaining the additional revenue that we need.

Thank you.

[The prepared statement follows:]

STATEMENT OF RICHARD GOODE, GUEST SCHOLAR, BROOKINGS INSTITUTION AND PROFESSORIAL LECTURER, SCHOOL OF ADVANCED INTERNATIONAL STUDIES, JOHNS HOPKINS UNIVERSITY

I am happy to appear today at the invitation of the Committee to take part in a discussion of tax reform. I do so in my personal capacity. Solely by way of identification, I may say that I am a guest scholar at the Brookings Institution and a professorial lecturer at the School of Advanced International Studies of the Johns Hopkins University. From 1965 to 1981, I was director of the Fiscal Affairs Department of the International Monetary Fund. Earlier, I held other positions concerned with taxation and public finance. I do not pretend to speak for any of the institutions with which I have been connected.

Today I propose to discuss mainly the individual income tax with only incidental reference to the corporation income tax and with some comments comparing the individual income tax with so-called cash-flow taxes, consumed income taxes, and consumption taxes.

About 71 years ago, the Ways and Means Committee in reporting the first income tax bill after the Sixteenth Amendment called the income tax the "fairest and cheapest tax" and drew attention to its potential for elastic revenue yield.

The Committee's characterization of the income tax as an elastic revenue producer was soon confirmed, when the individual income tax became an important source of finance during World War I. During World War II, Congress again looked to income taxation to help meet heavy demands for revenue. The individual income tax became, for the first time, a mass tax, applying to most regularly employed persons as well as other income recipients, and the most productive tax in the Federal revenue system. It still occupies that role. The individual income tax is also used by the majority of the states and by all other industrial countries.

The attraction of the individual income tax is not merely its capacity to yield large amounts of revenue, important as that is. If revenue were the only consideration, a value added tax or another broad indirect tax would be the best choice. The advantage of an income tax is that it conforms to the principle of ability to pay. Income in my opinion is the best measure of ability to pay. Furthermore, the amount of income tax payable can be adjusted to take account of individuals' personal circumstances, including the number of their dependents and other relevant factors. Rates can be progressive.

In the past, there was wide, though never universal, agreement that these characteristics made the individual income tax the fairest and best tax. Lately, however, there are signs of a major shift of opinion. Two public opinion polls conducted for the Advisory Commission on Intergovernmental Relations can be citied as evidence. In a 1972 poll, a plurality of respondents considered the income tax the fairest of all taxes used by the Federal, state, and local governments. But in 1983 a plurality voted the income tax the least fair. Among economists and lawyers, a direct tax on consumption expenditures, long considered no more than an impracticable academic curiosity, is attracting support as a substitute or supplement for the individual income tax.

We need to ask why the standing of the income tax has been declining and to consider whether radical changes should be made.

One reason for a less favorable attitude toward the income tax, in my judgment, is the overuse of special provisions to relieve hardship and to encourage certain activities. A direct tax, such as the income tax, lends itself to those non-fiscal uses. If carefully and moderately applied, that can be a source of strength, but careless and excessive application can cause many problems.

There has been a rapid increase in the number of special provisions or preferences in the income tax and in their revenue cost, especially after 1979. The Joint Committee on Taxation and the Congressional Budget Office identified 104 provisons in effect in fiscal year 1982 that they classified as tax expenditures. Between 1971 and 1982, tax expenditures grew from the equivalent of 25 percent of Federal revenue to 41 percent. The biggest ones were of long standing; more than three-fifths of the amount of estimated tax expenditures in fiscal year 1982 related to provisions predating World War II. Nevertheless, the proliferation of tax expenditures is disturbing and may become more costly as people learn how to exploit them more fully.

Many people appear to regard some of the tax preferences as unjustified and beneficial mainly to the rich. The existence of the provisions complicates the income tax. Economists point out that some of the special provisions induce changes in activity and forms of business organization that serve no clear public purpose and that hence should be classified as economic distortions.

By attempting to do too much with the income tax, Congress has seriously impaired the prestige of the tax—and possibly has damaged its own prestige.

Popular dissatisfaction with the present state of the income tax may also be associated with beliefs about the prevalance of abuses in the form of excessive deductions for business expenses, improper tax shelters, and outright evasion. The extent of abuses may well be exaggerated in the public mind, but that guess can't be confirmed in the absence of hard evidence on either popular beliefs or the facts. Certainly, the estimates of tax evasion published by the Internal Revenue Service are disturbing. Enforcement efforts have been inadequate. Audit coverage of individual returns has fallen from 2.6 percent of all returns in 1976 to 1.3 percent in 1984.

Another likely cause of the decline in the public opinion rating of the income tax after 1972 was its interaction with inflation. The decline in the real value of personal exemptions and bracket creep caused the taxes of many persons to increase faster than their real income during the 1970s. During a period of inflation, people may feel irritation or anger because increases in their money income do not enable them to buy the additional goods and services that they expected. Because the income tax is a visible tax, especially for those whose liabilities are not fully covered by withholding on wages and salaries, irritation or anger would be likely to focus on it even if the tax did not rise in relation to income. When income tax liabilities rise faster than income, the irritation or anger is more pronounced.

Inflation also distorts the measurement of taxable income. The 1981 liberalization of capital cost recovery provisions for taxing profits was supported partly as a means of compensating for the erosion of the real value of historical cost depreciation allowances. However, it failed to do that satisfactorily, and it resulted in widely different effective tax rates on economic income—rates that bear no identifiable relation to a well-considered industrial policy.

Nothing has been done to correct the adverse effects of taxation on recipients of interest income or to moderate the gains realized by debtors. Inflation forced up nominal interest rates to compensate lenders for the falling real value of loans, though with a lag and imperfectly. The compensation for inflation received by lenders and paid by borrowers is not interest in the real sense but partial amortization of the debt. Lenders had to include that amortization in taxable income and often suffered negative after-tax returns. Borrowers, on the other hand were undertaxed because they were allowed to deduct from taxable income not only real interest but partial amortization of debt. Lending was discouraged and borrowing encouraged. At times nominal interest rates probably were pushed up higher than they would otherwise have been. These effects were less widely appreciated than those of bracket creep, but they may have contributed to dissatisfaction with economic policy.

The direct nature of the income tax and its large size tend to make it a target for the opposition of those who have been led to believe that Americans are overtaxes. That belief has gained credence despite the fact that the ratio of taxation to GNP has been lower in the United States than in all other industrial countries except Japan and in some years Switzerland. And despite the fact that we seem to favor government expenditures much greater than the current level of taxation.

For a long time, tax reformers have argued that the income tax could be greatly improved by broadening the base by eliminating unjustifiable exclusions and deductions and simultaneously lowering nominal rates. I still accept that prescription.

Of course, many detailed questions would have to be answered in devising a set of specific proposals for base broadening. I take it that the purpose of the Committee today is to discuss broad principles rather than the details.

I do, however, wish to mention an especially important set of problems stemming from tax arbitrage. Tax arbitrage is a process by which costs properly attributable to obtaining income that is either tax free or preferentially taxed are deductible against fully taxable income. The costs usually are interest payments or capital cost recovery allowances. The result can be a very low or even negative effective rate of tax on the preferentially taxed activity. Established firms and wealthy individuals are favored. The outcome is unfair and economically inefficient. The abuse can be attacked from two sides—by restricting preferential taxation of income from certain sources and by further limiting the deduction of investment interest.

In my opinion, legislative reform should be accompanied by stricter enforcement made possible by increased appropriations for audit and by extended withholding.

The interaction of the income tax with inflation presents difficult technical problems and more fundamental issues. It would be technically feasible to index the personal exemptions, rate brackets, depreciation allowances, and the basis for capital gains and losses. I do not think that there is any fully satisfactory solution for treatment of interest income and interest payments, though some improvements may be feasible. The deeper question is whether we should try to make taxpayers more comfortable with inflation and in doing so perhaps contribute to its perpetuation. Full indexing throughout the economy can hardly be imagined because it would imply that the economic and political forces that bring about inflation could be negated by a technical device that compensated for price increases. Should we nevertheless try to index the tax system as fully as possible?

In recent years, the proposal to achieve tax reform by moving toward a more comprehensive income tax with lower but progressive nominal rates has been challenged by advocates of some form of direct consumption tax or cash-flow tax. The debate about the budget deficit has also stimulated interest in an indirect tax on consumption in the form of a retail sales tax or a value added tax.

The proposals for a new indirect tax have long drawn support from persons who wished to de-emphasize progressive taxation. They are advanced now, not as fundamental reforms, but as allegedly realistic measures for reducing the excessive budget deficit. We may find that it will be impossible to reach agreement on a better way of cutting the deficit. But I would urge that before coming to that conclusion, we consider at length and in detail the possibility of closing the budget gap by some combination of expenditure reductions and increases of direct taxes, which would accord better with ability to pay than any indirect tax can.

I wish to mention briefly some reasons why I consider the improvement of the income tax a better route to reform than the substitution of a direct tax on consumption (usually called an expenditure tax) or a cash-flow tax. Since others presumably will describe these measures in detail, I can be very brief in identifying them. The expenditure tax would be a direct tax on consumption expenditures, assessed like the income tax on individuals, with personal exemptions and (in most proposals) graduated rates. Consumption would be indirectly measured as the difference between certain receipts and certain outlays. Although proposals differ somewhat as to details, generally accountable receipts would include all forms of gross income and proceeds of sales and conversions of assets. Accountable outlays would include purchases of investment assets and additions to bank accounts. The cash-flow tax, as recently proposed by Aaron and Galper would be the same as the expenditure tax, with the significant proviso that gifts and bequests above an exempt amount would be taxed to the donor as consumption. The Hall-Rabushka proposal, though it looks different, is in fact equivalent to a truncated expenditure tax at a rate with personal exemptions.

The first reasons for preferring the income tax to the alternatives is that we have had more than 70 years of experience with the income tax in the United States. Taxpayers and the IRS are familiar with the income tax. Its features and its strengths and weaknesses have been analyzed in great detail in scores of committee reports, in hundreds of judicial decisions, and in thousands of articles in economic journals and law reviews, as well as in numerous treatises and handbooks. The income tax is used in one form or another in nearly all countries, which enables us to draw on the experience of others and which facilitates international economic relations.

A second, more important reason for preferring the income tax is that, in my opinion, income is a better measure of ability to pay than consumption is. Income is a broad measure of one's command over resources. Saving is an individual decision that does not lessen one's capacity to contribute to the support of the commonwealth. With comparable rates, a consumption tax would be greater than an income tax in years when consumption expenditures are large relative to income. Thus the consumption tax would tend to be heavier for young families and the elderly than for the middle aged, and for everyone it would be heavier in years of unemployment or poor business than in good years.

A third reason for preferring the income tax, is that adoption of one of the alternatives would remove a desirable check on the accumulation of personal wealth and the exercise of power that accompanies wealth. The cash-flow tax proposed by Aaron and Galper would apply when the accumulator transferred his or her wealth; it would thus exercise a check on the growth of family fortunes over generations but not on wealth accumulation during a person's lifetime. In my judgment, the cash-flow tax is clearly superior in that respect to an expenditure tax that omits gifts and bequests from the base. Still better in my opinion is an income tax including constructive realization of capital gains on gifts and bequests, accompanied by an effective separate tax on transfers. The recent trend of legislation, however, is not encouraging for supporters of either the Aaron-Galper version of a cash-flow tax or the alternative I prefer.

A fourth reason for preferring the income tax is that, in my judgment, it is simpler than the expenditure tax or the cash-flow tax. This statement contradicts the frequent assertions that simplicity is an advantage of the alternative taxes. I find these assertions unconvincing. Surely, the alternative taxes would be more complicated for the large number of persons who can now file short forms for the income tax because they would have to report transactions affecting their assets and liabilities. All errors and omissions would affect the tax base dollar for dollar because taxable consumption would be derived as a residual. I think that everyone who is experienced in accounting or statistical work is wary of estimates derived as residuals. Under the income tax, one has to report conversions of assets and changes in bank accounts only as they affect net income. Omission or understatement of a capital transaction may allow one to escape tax on a capital gain; under the expenditure tax or the cash-flow tax, taxable consumption would be understated by the full amount of the proceeds. To guard against such errors, I think that it would be advisable to require taxpayers to submit full balance sheets. The Hall-Rabushka proposal would be simpler than the other proposals, through in my opinion less simple than the authors maintain. But simplicity would be obtained at the cost of eliminating rate graduation and (apparently) omitting from the tax base consumption expenditures financed by interest receipts from government bonds, income receipts from abroad, capital gains, and use of accumulated assets.

To be sure, the expenditure tax and the cash-flow tax would dispense with the need for measuring capital consumption through depreciation accruals. In that respect, they would be simpler than a tax on economic income (though not simpler than the present income tax incorporating arbitrary capital recovery allowances). But far too little attention has been given to possibilities of abuse through strategic timing of receipts and disbursements in a graduated consumption tax. This already occurs in the case of personal income of taxpayers who report on a cash basis; under the alternative taxes the cash basis would apply to business income as well. The social saving would be less than any saving of accounting effort for tax purposes because accrual accounting would still be needed for other purposes and for tax purposes in respect of international business and investment.

Although we are well aware of difficulties of compliance and administration under the income tax, we are unfamiliar with the alternative taxes and can hardly foresee all the difficulties that would arise. Only two countries—India and Sri Lanka—have tried to apply an expenditure tax; in both it was a dismal failure.

A disadvantage of a shift from income taxation to consumption taxation is that complex transition provisions would be required to prevent unfairness to persons who, having accumulated retirement savings from taxable income, would find themselves taxed on the basis of consumption as they used up their savings. Complications would arise concerning the taxes of persons who move into the country or out of it.

Advocates of an expenditure tax or a cash-flow tax tend to assume that the new tax would contain none of the preferences or other special provisions that impair the income tax. I find this quite unrealistic. Some of the largest so-called tax expenditures are associated with deeply embedded beliefs about fairness and public policy. These and other provisions are supported by vocal interest groups. Examples include the preferential treatment of owner-occupied houses, the medical expense deduction, for charitable contributions, and the exclusion of employee fringe benefits. I doubt whether it would be easier to eliminate these preferences from an expenditure tax or cash-flow tax than to remove them from the income tax.

Admittedly, an expenditure tax or cash-flow tax would be less distorted by inflation than an income tax is. Everyone could make his or her own allowance for inflation in deciding how much to spend or save. This I regard as the strongest argument for the alternative taxes. But is it strong enough to decide the debate? Are we so pessimistic about our ability to deal with the economic and political causes of inflation that we should make a far-reaching, permanent change in the fundamentals of our tax system in order to cope with the distorting interaction between inflation and taxation? Recall that, at the cost of some complications, we could greatly lessen the effect of inflation on the income tax.

Sometimes it is argued that a switch to an expenditure tax or cash-flow tax would stimulate saving. Both the theoretical arguments and the empirical evidence on this question are inconclusive. I am inclined to agree that a consumption tax is more favorable to saving than an income tax is, though I am uncertain about how big the difference is. But for the foreseeable future the argument is virtually irrelevant for public policy. By far the most effective way of increasing saving for private investment would be to reduce or eliminate the budget deficit, which must be classified either as a huge negative item in national saving or a huge use of private saving.

My conclusion is that the individual income tax is still our best tax but that an overhaul of the tax is urgently needed. The base should be broadened by elimination or restriction of exclusions and deductions that are not justifiable in present circumstances. Nominal rates should then be reduced but not enough fully to offset base broadening. Income tax reform would be the best way of obtaining the additional revenue that we need.

Mr. HEFTEL. Thank you very much.

I wonder if, Mr. Galper, Mr. Aaron, Mr. Hall, Mr. Rabushka, if you have any observations you would like to make of your own before I address any questions I may have, based upon what you have heard each other say and Mr. Goode say.

Mr. Hall?

Mr. HALL. I would like to respond very briefly to what Mr. Goode just said, with respect to what is an income tax and what is a consumption tax. I think the crucial difference and the reason that we would probably in some sense like to call our tax an income tax is that the thing that goes on to your tax form is income.

We don't attempt to figure out how much each person consumes and then tax them on their consumption. If you did, you would get into all the problems that the cash-flow consumption tax does, for example, the burden that it puts on the young for which there are special complications of the tax.

I think it is a mistake to say that a consumption type of tax is one that literally figures out how much each family consumes. It is utterly unnecessary to do that in order to get the benefit of a consumption tax which is simply to provide the right investment incentives.

You can get that just by taking the current income tax and replacing the hodgepodge of investment incentives we have today, with a straightforward incentive, namely, a first year writeoff.

That is all it takes to get the economic benefits in this business of trying to attract individual compensation. And all the problems that go with it is utterly unnecessary and we think a mistake.

Mr. Goode also asserted incorrectly that our tax failed to tax the accumulation of wealth. And that is wrong. Again, that would be true of a consumption tax of the cash-flow type. But our tax which is a straightforward income tax, people would be paying the tax as they accumulated the wealth.

So there would be no problem and no defect of the tax as we have constituted it. Again, I see that as an advantage of our approach to the development of a tax which has the resource allocation advantage of a consumption tax, but none of the disadvantages of a tax which literally tries to figure out how much each family consumes.

There is no line on our tax forms which tells you how much someone consumes. It is an income tax. The effect of it—one way to look at it is that the effect of our tax system is to tax people's income on the basis of how much compensation it will ultimately finance.

That, I think, is just the right way to go about taxing consumption.

Mr. HEFTEL. Thank you. Mr. Aaron.

Mr. AARON. I guess I have two comments. One is a fundamental issue raised by the Hall-Rabushka plan. The other is the old, tired issue of whether the income tax does or does not discriminate against saving.

The issue that the Hall-Rabushka plan raises is whether one should tax people on an ex-post or ex-ante basis. What do I mean by that?

What I mean is that in the course of economic activity, everybody is exposed to random events, some of which turn out surprisingly well, some of which turn out poorly. I may buy a stock that goes up a lot or one that goes down a lot.

Under the ex ante Hall-Rabushka approach, one looks only at earnings at the individual level. If one then invested those funds and does especially well or especially poorly, that fact is of no relevance to the calculation of personal tax under the Hall-Rabushka plan.

If I bought land just outside Houston 40 years ago and now am the possessor of something which I can sell and realize many millions of dollars from, that income in no way would affect the tax liability under the Hall-Rabushka plan.

The ex-post approach, which I think is the principle on which the current income tax rests, is that you want to take account of the experience that people actually have. How did events turn out? Did they do well? Did they do poorly?

That is what we should base tax on. It is logically possible to advocate either of those approaches. My view is that the ex-post approach which underlies the plan that Harvey Galper and I put forward and that underlies the current income tax is a more equitable and a fairer one, and would be so regarded by most Americans.

But as I say, other people might disagree. Knowing the colleagues to my left, they would put forth a strong argument in opposition.

The issue of whether the income tax does or does not discriminate against savings is unanswerable in those terms, but is straightforward and a very simple question when put in the terms that Harvey Galper used in his testimony.

If I earn a $1,000, I have in the absence of taxes a certain ability to consume today. I have a certain ability if I save those funds to consume in the future.

If I face a 50-percent rate and I can save at an interest rate of 12 percent, my capacity to consume today is reduced 50 percent by an income tax. My capacity to consume 16 years from now, however, is reduced 80 percent. In that sense, the income tax falls disproportionately on those people who wish to use their purchasing power in the future and it taxes much more lightly those who wish to consume today.

That is a simple matter of arithmetic. The income tax does discriminate against people who wish to use their resources to consume in the future compared to those who wish to consume today.

Mr. HEFTEL. Thank you.

My original attraction to the concept of the progressive compensation tax of the cash-flow type was totally based on the manner in which I felt the present system was generating compensation as opposed to savings.

And that if you wanted to bring down interest rates and increase productivity, what you wanted to do was attract dollars of investment, a higher percentage that was going on in this country, which at that time was less than 6 percent—I think Japan is now over 20 percent—I think the major factor in generating investment dollars, impacting on interest rates, and impacting on productivity.

I have no other questions or observations I think at this time. I might ask just for clarification, Mr. Hall, if I have the 40 acres outside of Houston—I wish I did—and I sell those acres, under your proposal, is it correct that the receipts from the sale of that land are never taxed?

Mr. HALL. No. This is a good opportunity for me to reply, I think, a little more generally to the mistaken analysis of what we have in mind. Let me just answer your specific question first.

Investment—land held as an investment would be counted as a business activity and taxed.

Mr. HEFTEL. The ownership of land, buildings, stock, is all business activity.

Mr. HALL. No, no. Let me clarify this. The dividing line is between real business assets, what the law calls personal property and real property, which would be equipment, structures, and land.

Mr. HEFTEL. Those are all business?

Mr. HALL. Those are real business assets, and those get first year writeoff when they are acquired and the sale is fully taxed when sold. So all capital gains on real business assets are fully taxed.

Mr. HEFTEL. All land is business activities.

Mr. HALL. All land not used for a private home. Land speculation would be considered a business activity.

Now, financial assets, that is, claims on businesses that operate through the stock market or so on would be treated a different way. The business itself files a tax return. That is what is different about our system.

The business itself has paid a tax. A financial claim on it, like stock ownership, is a claim on what is left in the business after it has paid its tax. So if you go to the example that Mr. Aaron just indicated of somebody who does unusually well in the stock market, he created the impression, which is utterly wrong, that that capital gain is somehow untaxed to the individual.

But if you look behind it that capital gain occurs because the business has done well. That business has paid its own taxes.

He left form 2 out of the analysis. Counting the fact that the business is paying a tax itself at the 19 percent rate, then the capital gain that occurs is an after tax capital gain.

In other words, that stock is a claim on what is left in the business after the 19 percent tax is paid. Therefore, although the individual himself has not paid the tax, the tax has been paid for him by the business.

Now, that gives rise to enormous simplification and improvement of the performance of the tax system. As you know, the taxation of capital gains today, just like the taxation of dividends and interest is very tricky because there are tens of millions of taxpayers who receive them.

They are generated from only a few thousands of businesses. Many of the taxpayers don't bother to include them on their tax returns.

We solve that problem by centralizing the taxation of business at the business level. Let me go back to the original point.

We tax all capital gains through the use of the business tax. We tax the capital gains on business assets directly in a straightforward way, and we tax the businesses themselves on what they earn—the claimants on the businesses, the shareholders are taxed because of the fact they have a claim only on the after tax income.

It is wrong to claim there is some ex-ante and ex-post distinction of that type which says we ignore the good fortune of the taxpayer and the bad. What is right, there is a valid ex-ante, ex-post distinction here, it is the one I made before, which is that we tax people the moment they receive their income on the basis of the amount of compensation they can later finance.

So we have an income princple of taxation. It is not ex ante and ex post in that we ignore the good or bad fortunes of the taxpayer. That is quite wrong.

Mr. **Heftel**. In terms of neutrality, and judging by individual application in terms of fairness, if at the time your proposal were to be implemented a taxpayer owned 1 million dollars' worth of publicly held stock, that taxpayer would be able to sell that stock with no tax consequences, would be able to buy other forms of stock, again, with no tax consequences.

Now, to say that is going to be more or less fair, more or less neutral, is a matter for discussion. But am I correct that the ownership of the stock and the resultant proceeds from sale would not be a taxable consequence and that the reinvestment in stock would continue to be not a taxable event?

Mr. **Hall**. Well, let's be clear.

Mr. **Heftel**. We know about the fact that the corporation pays taxes. So we don't have to repeat that. We are just saying if you hold the stock, and you sell it, and you rebuy stock and sell it, that is never a taxable event. We need a yes or no.

It is very critical. And it cannot be complicated by what the corporation does in terms of paying taxes. We are only addressing the ownership of the stock.

I think it is critical to understanding your proposal—not necessarily condemning it. We have to know yes or no, do I or do I not develop a taxable consequence from the ownership of that stock.

Mr. **Hall**. My answer is yes, but.

Mr. **Heftel**. You do or you don't. If I have 1 million dollars' worth of stock which I sell for $2 million, do I pay a tax on the $1 million gained from the sale of the stock?

Mr. **Hall**. You do not pay a tax at that moment.

Mr. **Heftel**. That is all I want to know. If I die and leave the stock to my heirs, do my heirs pay a tax on the receipt of that stock?

Mr. **Hall**. No.

Mr. **Heftel**. All right. Therefore, we have a scenario, and if I am incorrect, I will be glad to have you correct me—we have a scenario in which I, as the owner of stock—and I will concentrate only on publicly held stock, because I have no control over that in the sense that I am somehow combining this with the way I operate a business—I own that stock and I sell it, I do not pay the taxable even when I sell it.

When I buy other stock and subsequently sell that, I do not create a taxable event. When I die and leave that stock to my heirs, I do not create a taxable event. Therefore, I am assuming the society will quickly understand that if I can get all of my equities into publicly held stock, I can go on interminably never paying a tax in the benefits from the sale of that stock or the transfer of the ownership of that stock.

Mr. **Hall**. The businesses are all paying a tax for you.

Mr. **Heftel**. Sir, that has nothing to do with the treatment of the stock itself. I don't combine the two. That only confuses the issue.

All you are saying is you are going to have the corporations pay more tax perhaps than they pay now. That still has nothing to do with the ownership of the stock.

What I see is a potential lack of neutrality, a potential movement of capital assets into stock which is not taxed.

Now, I would be glad to have you tell me if I am wrong. But don't combine the fact that the corporations are paying tax.

Mr. **Hall**. With respect to the issue of neutrality—you raise two separate questions. One has to do with the administration of the system. We have chosen for very good reasons to centralize the administration, the collection of taxes on business activities at the business level rather than the individual level.

Now, so we have clarified that point. You are quite right that tax events do not occur as people shuffle around their portfolios of stocks, bonds or any financial claim. It is not just stocks.

There is no particular special treatment of stocks here.

Mr. **Heftel**. But, sir, stocks and bonds will not be taxed as I sell them. I understand if I lose I don't have any kind of an offset for anything, because I don't have a tax to offset it against. But obviously if I buy land and sell it, if I buy equipment and sell it, if I buy anything in the operation of any kind of a business or business interpretation, as I buy and sell it, there is a taxable consequence.

As I buy stock there is none. And I just wanted to clarify the point. I didn't want to confuse it with the way you elected to tax a corporation at the business level. Because that has nothing to do with the ownership of the stock. They are totally unrelated issues.

Mr. HALL. I agree with what you said. But your question got into the substantive economic issue of whether or not there would be a bias or distortion of the economy.

Mr. HEFTEL. There could be from what I think I hear and see from this. You may disagree with that. That is an interpretation.

And I would be interested in whether some of the other gentlemen see an interpretation that would lead to a distortion in terms of the treatment of the publicly held stock.

Mr. GALPER. In fairness to Hall-Rabushka, I think they are really spelling out the consequences of an integrated corporate and individual tax system. If you had the same 19 percent tax which they impose at the business level taxed exclusively at the indivdiual level, and no tax at all at the business level, that would be the same as what they are saying.

But from the way you are asking the question, I get the impression you think that might give rise to some different result.

Mr. HEFTEL. If I, as an individual, can invest in a variety of things, one of which is publicly held stock, and the publicly held stock does not produce a taxable consequence to me, the orders are that I am going to focus my investment energy and talent on that activity, because it doesn't have a taxable consequence.

Mr. GALPER. A couple of points. One, it has taxable consequences—but I should say I am not a supporter of the Hall-Rabushka proposal. But it would have taxable consequences to the extent that the return that is available to the individual has already been reduced by whatever——

Mr. HEFTEL. I understand that if corporations are taxed at a level so high that the investment in the stock is not attractive, that you won't invest in the stock.

Mr. AARON. I think if every corporate stock sold for a certain—for a certain multiple of accurately forecast corporate earnings, what they say would be correct. Because what you would have would be a corporate tax that would reduce corporate earnings and that would accordingly reduce the value of the stock dollar for dollar.

But we all know the world doesn't work that way. The fact of the matter is that corporate stocks sell for hugely fluctuating multiples of the actual earnings histories of those corporations, because of erroneous projections on the part of investors, as a result of which individuals realize enormous capital gains and losses, none of which would be taxed under the Hall-Rabushka plan.

The expected value principle works out just fine. But it is those deviations that give trouble.

Mr. HEFTEL. Knowing human nature, knowing the nature of how we direct investments by what we do with the Tax Code, it is reasonable to assume if there is a way to invest advantageously in stock because it is not taxed in the matter in which you transfer or sell it, that is where your economic activity on the part of individual investors will occur—in the same sense you pointed out there is no taxing, there is a negative tax implication for partnership.

The reason is partnerships are basically today generally limited partners. The limited partners get all the tax advantage. The general partners get whatever profit advantage there is from the operating of the business.

And the limited partners invest in the partnership in the first place because they are going to gain a tax offset against other income. And just as you have seen the partnership converted into a tax hedge, that is in a sense what would happen with people understanding, I can invest in stock and I won't have to pay tax.

Mr. **Galper**. That is indeed the ex-post, ex-ante point that Mr. Aaron was making earlier. If you think you can beat the system and you invest because you think you can get a higher than normal rate of return, you may win, you may lose; but the winners are not going to be taxed as a result nor will the losers get deductions.

And so even though while this 19-percent rate might apply on average, those who in fact realize large capital gains will not be taxed on those gains.

Mr. **Heftel**. Everybody will think he can do it better than anybody else. That is where economic activity or investment will occur. I think you then have to make a judgment, will it distort the way investments occur, and is it going to fail the test of neutrality.

And I think that if there is an objective in all of what we are talking about, it is investment neutrality, and I don't know whether you are going to achieve it with what you have just described.

Mr. Goode.

Mr. **Goode**. There is one other point that might be made, Mr. Chairman, as far as I understand the Hall-Rabushka plan, and I might be incorrect. If you own stock in a nonresident corporation that operates abroad, you won't be taxed under the Hall-Rabushka plan. They can't rely on the collection at the source argument for that case, as far as I can see.

That would be a case where there would be a possible perverse incentive created.

Mr. **Heftel**. It would depend on whether the foreign investments were turning out to be better investments than the American corporation. And that will always be true.

I think the real test is going to be do people decide to go for the nontaxable economic event, and if they do, you have a built-in distortion, and I didn't know whether there was a misunderstanding, and I wanted to be sure before we left I personally did.

To the extent others can evaluate it on their own, that is what they will do. I thank you very much.

Thank you. The committee stands adjourned until 10 o'clock tomorrow.

[Whereupon, at 2:25 p.m., the hearing was adjourned, to reconvene at 10 a.m., Thursday, September 27, 1984.]

TAX REFORM AND DEFICIT REDUCTION

THURSDAY, SEPTEMBER 27, 1984

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

Thank you gentlemen for joining us this morning. As you know, we will be looking at fundamental tax code revisions next year. There is certainly a great deal of interest on the part of the members to consider changes that may be necessary. We are pleased that you are here to share your views and to give us your perspectives as to tax restructuring proposals next year.

This weekend the committee will be working with members of our staff and an impressive faculty on a tax retreat to explore both the problems and possibilities of the next Congress.

Mr. Harriss and Mr. Calkins, thank you very much for joining us.

STATEMENT OF HUGH CALKINS, CHAIRMAN-ELECT, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, ON HIS OWN BEHALF

Mr. Calkins. Although I am chairman-elect of the Section of Taxation of the American Bar Association, I appear today solely in an individual capacity. My testimony has not been approved by and should not be viewed as reflecting the views of the American Bar Association or its Section of Taxation. I am, however, grateful for the opportunity to review with the committee conclusions which I reached when I served as chairman of the special committee of the section of taxation appointed in 1971 to conduct an intense study of value-added taxation.

I propose to open with some reflections of my own relating to the role of the value-added tax in the tax dilemma that the committee and the country confront. I will then go on to respond to specific questions related to consumption taxes which my committee addressed when we studied it.

There are, it seems to me, three practical, broad alternatives which face this committee and the country. One of them is to continue the course which is typified by TEFRA and DEFRA, and attempts to increase tax revenues somewhat by tightening and tinkering with the present Internal Revenue Code. While that course to me is a better one than the course which we followed in the preceding two decades, in which we steadily narrowed the tax base by providing more and more incentives to more and more activities, it is not a course which I would urge this committee to follow. Indeed, most of the members of the tax bar of my acquaintance are appalled and discouraged by the prospect that TEFRA and DEFRA will be followed successfully year after year by similar legislation. We are more aware than most citizens of the enormous difficulty of effectively closing loopholes in an Internal Revenue Code which is designed for incentives as well as for revenue. A tax system which offers ACRS, investment credit, IDB's, leverage leases, tax favored health and insurance arrangements, IRA's, ESOP's and all the other incentives of our present law, offers about as much resistance to creative tax planning as would the dikes of Holland to the North Sea if they were made of brussells lace.

A thousand pages a year of code amendments and the conference committee report will not begin to close the Federal deficit and will overwhelm businessmen in a skein of complexity as intricate as a spider's web. I urge this committee to decide that almost any other course is preferable to that alternative.

The second alternative is to return the income tax law to what it basically was for the many decades that preceded 1962. During those decades we thought of the income tax as a way of raising revenue and, in general, we tried to design it in such a way that it would equitably and effectively raise revenue. It is astonishing to review in the light of our experience today the reports of this committee accompanying all the revenue acts up to the Revenue Act of 1962, because they all reflected the objective of the Congress to use the income tax to raise revenue. Only very seldom did they indicate that there was to be an incentive for other collateral purposes.

All that changed in 1962. We have since 1962 been using the tax law to stimulate the economy in 100 different ways, with what I think are disastrous results. So the second alternative before this committee and the Congress and the country is to return to an income tax for revenue only.

That is not the subject of this morning's discussion. I have spelled out my views on that subject at some length in an article in Tax Notes last spring and I will not dwell on it now. I mention it because I think it is a second realistic alternative that is before this committee and the Congress, and it is in fact the one of the three that I most prefer.

The third alternative, which is the one that we are concerned with in these hearings, is a combination of a broad-based, substantial income tax reform, substantially broadening the income tax base and reducing its rates, with a consumption tax. That is the context in which we are conducting this hearing today and it is in that context that I would like to address a consumption tax.

I would like to start with why is it that I think this committee should consider a value-added tax or a national sales tax only in conjunction with a broad-based revision of the income tax such as typified in the Bradley-Gephardt or Kemp-Kasten proposals. The first reason is that we do not need a consumption tax unless we have a broad-based income tax reform. We should not add another large, new, complicated tax to our tax structure unless we have a very important reason for doing so.

The second reason is that if we go to a major reform of the income tax, reducing the rates and broadening the base, then in my judgment we will have to have either a value-added tax or a national sales tax along with it. Everything that I have read about Bradley-Gephardt and Kemp-Kasten says that those proposals are not going to increase revenues at all. It is probable that they will result in some reduction in revenues. There is growing agreement that we must do something to close the Federal deficit.

Therefore, as I see it, looking at practical alternatives this committee is addressing today, there should be a value-added tax or a national sales tax, if, and only if, the committee also decides to go forward with a program for a major broadening of the base and a major reduction of the rates in the income tax.

I now propose to ask and answer seven questions:

First, which should the consumption tax be—should it be a VAT, or a national sales tax?

Second, should it be a limited tax with some kind of a cap on the amount of the yield?

Third, if so, how should it be limited?

Fourth, will it be complicated?

Fifth, if you choose a value-added tax, what kind of a value-added tax should it be?

Sixth, what should be taxed?

And seventh, will the tax be a good tax?

First, should a Federal consumption tax be a value-added tax or a national sales tax?

I suggest that it should be a value-added tax for three reasons. A value-added tax will contribute to compliance in this country much more than a national sales tax. A national sales tax at a 4- or 5-percent rate will raise sales tax rates generally in this country above 10 percent. Sales taxes above 10 percent will, I believe, create a significant enforcement problem.

The VAT tax is better than the national sales tax from an enforcement standpoint for two reasons: It is harder to cheat because you have to cheat on the purchase side as well as on the sales side, and that is more difficult. Moreover, if you do cheat you only avoid part of the tax because of the way the value-added tax operates. You pay a tax on everything that you buy even if you succeed in escaping taxes on the value-added tax.

Second, a VAT would be much easier for the Federal Government to impose from a political standpoint than would a national sales tax. Everybody thinks of sales taxes as belonging to State and local governments. A VAT tax, even though its impact is similar, sounds different and would be politically easier to induce.

Third, a value-added tax has a great advantage over a sales tax in that it will tax a larger segment of the economy, and will do so more accurately than a sales tax. It is easier to create exceptions for articles which are used in business and commerce under a value-added tax than it is under a national sales tax.

Those three reasons, in my judgment, outweigh the simplicity and familiarity advantages of a national sales tax.

Second, should the tax be limited? I think it is essential that, if a VAT tax is to be considered seriously by this committee, the committee invent a limitation on the tax. The single problem about a

VAT tax that most concerned the committee which I chaired, and which I most often hear, is that it is so productive of revenue. Even with a fairly narrow tax base, a 1-percent VAT tax in this country will raise $10 billion. A 5-percent VAT tax will raise $50 billion, and there is a great deal of concern that if Congress has the ability to raise another $10 billion by adding another percent on a VAT tax, Congress will give into the temptation to do so.

I, therefore, suggest that the Congress invent a limitation on the value-added tax. The limitation which I think it should invent is a relationship to State sales taxes. The value-added tax the Congress should consider is one which would be limited to some percentage—I will use two-thirds as an illustration—of the prevailing rate of State sales taxes. That will give some assurance to the States that they won't be overwhelmed by a Federal tax, and it will give some assurance to the country as a whole that this tax will perform its intended purpose of narrowing our budget deficit and will not give Congress an uncontrollable opportunity to increase expenditures.

I am not sure of the best method of imposing that limitation. I think I prefer some kind of a contact between the Federal and State governments, but a constitutional amendment might be an alternative, and even a self-imposed limitation, self-imposed by Congress and not really enforcible by anything except the self-restraint of Congress, might be an acceptable way to create a limitation. I see that the chairman and Mr. Conable do not think that self-restraint would work I therefore offer my first two suggested methods.

The idea of a contact with the State seems to me to be intriguing because one of the interesting corolaries to a national value added tax is that it might be possible to use it as a way of helping the States by piggybacking and thereby assisting in the administration of with consumption taxes in the United States.

The next question is, Will the value-added tax be complicated? The answer is yes, it will. Denmark administers the value-added tax with a tax return that consists of a postcard, but having studied the VAT tax for 4 or 5 years, I assure the Congress that won't happen in the United States. The question whether the automobile that is purchased partly for business and partly for personal use should be taxed and how the tax should be computed, is only one illustration of 100 complexities which will arise in the administration of the tax.

The European experience is that the cost to the government of collecting the value-added tax is about four times the cost to the United States of collecting our present income taxes. That is the result of the fact that the VAT covers so many people and there are so many transactions to be looked at, as well as the fact that the Europeans tend to spend more money than we do in enforcing their taxes.

What kind of tax should it be? The kind of credit value-added tax used in Europe.

What should be taxed? First, food. My committee felt that food should be taxed because it is so complicated to put multiple rates into the system. I personally did not agree with the committee on that subject then, and I do not now. I think it would be necessary as a political matter, and probably desirable as an economic matter, to have a lower rate on food, or perhaps exempt food, which is consumed off the premises.

Interest should not be subject to the value-added tax, but financial services like cashing checks and giving investment advice should be. Some of the complexities that I have mentioned will arise in trying to distinguish between those two activities of banks.

Housing would not be taxed under the value added tax which my committee contemplates, except that the cost of new construction and the cost of new materials that go into housing improvements would be taxed. Rentals would not be taxed.

Governments and charities under the the kind of tax that we contemplated would be treated like individual households--that is, they would be exempt. That means they would pay a tax on whatever they purchase but the additional value which they add in conducting the teaching in the classroom would not be subject to tax.

Capital expenditures would be subject to full credit with refunds if they exceeded the tax that was owing.

Transportation would be fully taxed.

Would that kind of a value added tax be a good tax?

No, it would not. No tax is a good tax. It would be complicated. There would be millions of taxpayers who would have to learn a whole new system, program their computers, and fill out new returns. There would be irritation and resentment.

A VAT tax is not a good tax and should not be adopted except in conjunction with a major change in our system, with a real reform of the income tax. But if such reform can be achieved, the combination of an improved income tax with broader base and lower rates and a value use added tax would present a better system than the one we have now. I repeat the advice with which I started this testimony. To most members of the tax bar, the current system is intolerable and getting worse. We need a significant change. The combination of a reformed income tax and the VAT tax would be better than what we have now.

[The prepared statement follows:]

STATEMENT OF HUGH CALKINS, CHAIRMAN-ELECT, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Chairman Rostenkowski, Members of the Ways and Means Committee: I appear here today solely in an individual capacity. My testimony has not been approved by and should not be viewed as reflecting the views of the American Bar Association or its Section of Taxation. I am, however, grateful for this opportunity to review the conclusions which I reached when I served as Chairman of a Special Committee on the Tax Section formed in 1971 to conduct an "intense" study of value-added and national sales taxation. I propose to divide my testimony into two parts. In part I I will summarize the conclusions I reached during the Special Committee's study as to the feasibility of value-added and sales taxation at the federal level in the United States, the choice between those forms of taxation, and the design of a value added tax.[1] I will include the relevant conclusions reached at a Conference on Tax Compliance sponsored by the Tax Section in March, 1983. In part II, I will review some conclusions I have reached more recently relating the VAT to our current national tax dilemma.

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[1] The Report of the Special Committee can be found in a Reprint published by Tax Management, Inc. and in Vol. 24, No. 3; Vol. 26, No. 1; Vol. 28, No. 2; Vol. 29, No. 3 and Vol. 30, No. 3 of Tax Lawyer.

I. SUMMARY OF CONCLUSIONS REACHED DURING COMMITTEE STUDY

A. The choice between a VAT and a NST

Both a VAT and a NST are feasible federal level taxes in the United States tax system. The VAT has both advantages and disadvantages as compared with the more familiar sales tax.

1. *The advantages of a VAT over a NST.*—The first advantage of a VAT over a NST is the greater opportunity it affords to achieve a broad tax base. Under a VAT, most services provided by independent contractors and suppliers can and I believe should be included in the tax base, and a significant share of the tax burden can and I believe should be borne by charitable, educational and health institutions. While these desirable results could be achieved with a NST, it is less likely that they would be.

Second, a VAT has an advantage over a NST because it is more likely to exclude from the tax base items of property which are purchased by businesses for business use. If such items are not excluded, the tax upon them is included in the base on which tax is again imposed, and the result is the undesirable "cascade" system in which the tax burden multiplies as unintegrated businesses sell to other unintegrated businesses further on in the commercial cycle. Once more, a NST could be designed with a total exclusion for business use, but the experience of states with sales taxes shows that the credit approach of the VAT is much more likely to achieve total business exclusion than the exclusion approach of a NST.

Third, my work with the Special Committee and the Compliance Conference has persuaded me that a VAT is superior to a NST from the standpoint of promoting compliance. There are two reasons for this conclusion. One is that a VAT requires retailers and suppliers or manufacturers further up the stream of commerce to report purchases as well as sales. It is both technically and psychologically difficult to falsify both reports in a consistent manner. Second, attention has recently been focused on the extent of the underground economy in the United States. It is believed to exceed 10% of our GNP. Participants in the underground economy do not pay state sales taxes. Under a VAT, while they also presumably would not pay tax on whatever value they added to their product or service, they would pay tax on whatever goods and services they purchased in the above-ground economy.

Finally, a VAT might be politically easier for Congress to introduce than a NST, since it would at least appear to be less intrusive into a domain traditionally reserved for state and local governments.

2. *The advantages of a NST over a VAT.*—To be weighed against these four relative advantages of a VAT as compared with a NST are two material respects in which the NST is superior to the VAT.

The first and most important is that it affects a smaller number of taxpayers and transactions, in a way which is already familiar. A NST would only tax retail sales and such sales to exempt organizations as Congress decided to include in the tax base. A VAT, as the Committee well knows, taxes all sales in the stream of commerce, and then by a credit system confines the burden of the tax to the consumer and to the exempt organizations which are intended to be included in the tax base. Retailers are much more numerous than any other kind of commercial or industrial firm. The number of taxpayers required to report under a VAT system is therefore estimated to be only a little larger than the number of reporting taxpayers under a NST system. Nevertheless, in our entrepreneurial society, millions of citizens engage in some business activity and will be required under a VAT to study, understand, establish manual or computer systems, file returns, remit taxes, seek credits, and be subject to audits. Studies have shown that the narrow based sales taxes in force at state and local levels are our most popular—or least unpopular—tax. The relatively low irritation factor associated with the sales tax doubtless contributes to its acceptance. Moreover, people understand sales tax concepts because of their extensive use at the state and local levels. A new type of tax would require a substantial amount of learning time that would be regarded by some as annoying and unproductive.

The other disadvantage of a VAT in comparison with a NST is its greater impact on cash flow. A NST has some positive or negative impact on the cash flow of a retail taxpayer, depending on whether a cash or accrual method of accounting is used, and on the timing of required remittances to the revenue authority. A VAT affects a larger group of taxpayers, and in a more complex manner. The VAT is included in the prices paid for acquired goods and services, subject to a credit, as well as imposed on sales, subject to a remittance obligation. By minimizing positive or negative cash flow impacts, a NST has a material advantage over a VAT.

B. The complexity of a VAT

A value-added tax appears on the surface to be simple to write and easy to apply. Based on the work of the Special Committee, I have concluded that in the United States economy a VAT would present its full share of drafting and administrative complexities.

A VAT allows the legislature to choose between two methods of reducing or eliminating the tax burden from activities and products which the legislature considers inappropriate to tax. Such activities generally include the essential operations of government, the health, educational and welfare activities of both private and public institutions, and the religious activities of churches and synagogues. Such products may include food, health care and housing.

One method of narrowing the tax base is by exemption. An exempt activity is one which pays no tax on its sales and is entitled to no credit on its purchases. It is treated as if it were a household consumer.

The other method is by reducing, to a lower rate or to zero, the rate of tax imposed on sales, while allowing credit in full for taxes paid on purchased goods and services.

Often, when exemption is used, exempt organizations are allowed to elect out of their exempt status if it is less expensive for them to pay the tax on the value they add than to pay it on the value they purchase.

Each of these methods of narrowing the tax base presents its set of drafting and administrative complexities. Use of multiple and zero rates requires vendors to distinguish among sales. Food consumed on the premises is taxable, but off the premises is zero rated or subject to a reduced rate. Meat and potatoes constitute food, but a TV dinner is, or is not, a taxable manufactured product, and beer and wine is, or is not, a taxable luxury. A publication of a university press may be a taxable book or a nontaxable educational product. A dance class may be a taxable recreational service or a nontaxable cultural or educational experience.

Exemption is relatively simple on the selling end, but can be very complex on the buying side. A university which is zero rated as to the educational services it provides is entitled to a credit (including a refund) for all of the VAT it pays. An exempt university, on the other hand, is entitled to a credit only for the goods and services it uses in a taxable activity. If the university press and certain uses of the auditorium and stadium represent taxable activities, how does the university determine the portion of its purchases of fuel oil, paint, toilet paper and thousands of other articles which are attributable to those taxable activities?

Similar problems arise at the household level. A proprietor or independent contractor generally collects and remits VAT on the goods and services he sells. He generally pays VAT on the goods and services he buys, and is entitled to a credit for those he uses in his taxable business activities. What about the car used partly for business and partly for personal use? Is the allocation to be made at the time of purchase based on an historical base period or on an estimate of future use? Or is there to be some retrospective allocation as each year passes? How can the taxing authority audit the computer purchased for business use and later appropriated to personal use?

There are no simple answers to these questions. My advice to Congress is only this: I urge that you recognize the magnitude of the irritation factor and the collection and audit effort and expense which is inherent in any broad based tax such as a VAT.

C. The specifications for a VAT for the United States

In theory, a VAT can be imposed on any one of three bases: credit, subtractive, and additive. A credit VAT reaches the "value-added" by a business taxpayer by imposing tax on sales and allowing credit for purchases. A subtractive VAT reaches "value-added" by imposing tax on the net of sales less purchases. An additive VAT reaches "value-added" by imposing tax on the sum of employee compensation, interest expense, rental expense and profit. The Special Committee strongly recommended the credit approach. It is universally employed by the countries which use VAT. It easily allows exemption of exports and taxation of imports. It has advantages from simplicity, compliance and definition of tax base standpoints.

While there was some difference of opinion within the Special Committee, I believe that a VAT in the United States should exempt but not zero rate health, education and welfare services, whether performed by private or public agencies. Such agencies should be given the option of foregoing exemption if that is advantageous to them. As earlier explained, exemption will require these organizations and governments to pay tax, as if they were households, on goods and services purchased by them. The charitable sector of our economy is growing so large that it is unwise to exclude it from the tax base by zero rating. Exemption of charitable and governmental organizations will require the development of elaborate rules to discourage vertical integration.

VAT paid on business expenditures for capital goods should be immediately creditable and refundable if in excess of VAT tax payable.

A VAT in the U.S. should exempt interest, primarily for equitable and political reasons. Financial services other than lending and insurance, such as check handling, stock selection and personal planning, should be taxable, perhaps using for simplicity standard measures of value rather than actual cost or actual charge.

The rental costs of the household and the imputed value of the use of an owned residence should not be subject to tax. However, tax should be imposed, either on the materials and appliances used in construction (and improvement) for rental or sale, or on such expenditures together with purchased construction, labor and services.

Transportation should be fully taxable, subject to appropriate correlation with the surviving federal excise taxes.

A majority of the Committee recommended that, contrary to European practice, food should be subject to tax at full rates, with a system of income tax credits and refunds to mitigate or eliminate the regressive effect of such a uniform broad base. I personally am uncertain about that conclusion; I would urge that Congress consider whether a reduced rate for food would be unacceptably complex.

D. Should a VAT or NST be enacted?

My study of the VAT identified seven considerations which are often considered most relevant to the choice among consumption, income and payroll taxes.

In my view three of these considerations are not likely in the end to be decisive on the outcome. They are: the relative impact of consumption, income and payroll taxes on inflation; the relative impact of the three forms of tax on the rate of capital formation; and the alleged regressivity and distorting effect of real estate taxation.

One of the four considerations which I think will be most influential is the extent of the preference for progressivity. In the words of the Special Committee, "Those who believe that the present degree of progressivity is insufficient will tend to favor raising additional revenue from extending the base and possibly increasing the rates of the personal income tax, while those who believe that the present system is sufficiently progressive to be equitable, or excessively progressive, will tend to look with more favor on a federal consumption tax, probably containing income tax credits to relieve the impact on lowest income taxpayers."[2]

A second influential factor, is inter-government policy. Opposition to the VAT will come from "those who find virtue in keeping decisions on levels of taxation close to the people, or are concerned that the entrance of the federal government into consumer taxation will hamper state and local revenue systems. . . ."[3]

Third, the judgment of appropriate governmental bodies about a VAT or a NST will be greatly influenced by their degree of optimism or pessimism with respect to expansion of the federal income tax base. To quote the Special Committee again: "Some, who have studied the question, have become pessimists on reform in the federal income tax, and have concluded that the political obstacles to achieving significant reform are insuperable. Others are more optimistic, and believe that additional federal revenues, in the amounts likely to be considered necessary, can be achieved by extending the income tax base. One's judgment about the desirability of seeking additional government revenues, if they are needed, from an increase in the federal personal and possibly corporate income tax will be significantly affected by one's judgment of the feasibility of broadening the base and causing the tax to apply more uniformly to all citizens and businesses."[4]

Finally, and most important of all, I have concluded that judgments about a federal VAT or NST would be affected by the answer one gives to this question:

"Is it desirable for the federal government to have a new tax source whose yield can probably be increased in the future, or is it wiser to meet whatever needs the federal government may be determined to have from the present forms of taxation?

Those who believe that the public sector in the United States is already large enough may be reluctant to equip the federal government with a new tax source which potentially can yield substantially more revenue than foreseeable immediate requirements dictate. . . ."[5]

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[2] 26 Tax Lawyer 45 at 76.

[3] *Ibid.*

[4] *Id.* at 75.

[5] *Id.* at 76.

On the other hand, those who believe that it is essential to close the federal budget deficit, and who doubt the ability of the federal income tax to furnish the necessary funds, may favor a federal VAT or NST as the least objectionable tax to accomplish at least a portion of the objective.

II. OBSERVATIONS ON THE CURRENT NATIONAL TAX DILEMMA

As I see it, Congress can in 1985 choose among three alternative courses of action. One is to continue the course exemplified by TEFRA and DEFRA. Under this course, no new tax is imposed; no fundamental reform of the federal income tax is introduced; income tax rates are not increased; and continued efforts are made in successive Tax Reform Acts to close "loopholes" and remove unintended benefits.

Most members of the tax bar of my acquaintance are appalled and discouraged by the prospect that Congress will adopt this course. More than most citizens, we are aware of the enormous difficulty of effectively closing loopholes in an Internal Revenue Code designed for incentives as well as for revenue. A tax system which offers ACRS, investment credit, IDBs' leveraged leases, tax-favored health and insurance arrangements, IRAs, ESOPs and all the other incentives of our present law exerts as much resistance to sophisticated tax planning as would be dikes of Holland to the North Sea if they were made of Brussels lace. An annual increment of 1,000 pages of Code and Conference Committee Report will not begin to close the federal deficit, and will overwhelm businessmen in a skein of complexity as intricate as the spider's web. I urge this Committee to decide that another course, almost any other course, is preferable to that alternative.

A second alternative is to return the individual and corporate income tax, more or less to what they were in the early 1960s. Until that time, they were, in general, designed to raise revenue and not shape the economy. Redefining taxable income so that it is much closer than in is now to the accountants' conception of book income could provide the revenue needed to—along with tight control of expenditures—reduce the federal deficit, and probably permit some reduction in rates as well.[6]

The third alternative is to combine the introduction of a VAT or a NST, at a low rate, with a substantial reform of the federal income tax leading to large reductions in marginal rates. I do not have any enthusiasm for a flat tax, because I think progressivity in the federal income tax is essential to a fair tax system. However, flatness of marginal rate need not be a part of a redefined and much broader federal income tax base. If the top marginal rate can be reduced to 30 percent, the special treatment of capital gain and most of our special provisions for savings and fringe benefits can be abolished, and much simplification achieved. As I understand the arithmetic behind the Bradley-Gephardt and Kemp-Kasten bills, no revenue increase and no progress toward reduction of the deficit can be anticipated from these income tax reforms. A VAT or a NST would be a necessary accompaniment, particularly if the income tax reform were accompanied by some reduction in payroll tax burdens.

The acceptibility of a VAT or a NST to Congress and to the Administration would be greatly enhanced if some way could be found to limit its yield. The greatest concern within the Tax Section's Committee about the VAT and the NST was the recognition that the yield of these taxes is so large and so relatively painless that the enactment of either one of them might constitute an invitation excessively to enlarge the share of gross national product consumed by the activities of the federal government.

I do not personally favor Constitutional amendments restricting the powers of Congress to spend. I suggest that Congress consider, as an alternative, an explicit or implicit compact with the states. The sales tax burden in this country is today about 6 percent. Raising it as far as 12 percent, and reducing income tax burdens, would bring this country into line with most of the developed world, relieve compliance problems, and possibly in time improve our savings rate. A commitment by the federal government to the state governments that the federal rate of VAT or NST will not exceed one-half or three-quarters the median state rate of sales tax is worth consideration. A VAT limited by such a commitment would provide the federal government with $50 to $75 billion it needs to close the budget deficit and permit substantial income tax reform, while maintaining pressures to limit federal expenditures which the Administration, the Congress and the public all desire. If Congress decides not to return the federal income tax to its orginal revenue-raising purposes, I

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[6] I have developed this alternative at length in an article entitled "A Federal Income Tax Designed For Revenue Only" published in Volume 23 Tax Notes No. 2 (Apr. 9, 1984).

urge that it consider as the best alternative the combination I have described of a capped VAT and a reformed income tax with lower rates and a broadened base.

Chairman ROSTENKOWSKI. Thank you very much. Mr. Conable is recognized.

Mr. CONABLE. Mr. Chairman, let me say hello to my old friend, Professor Harriss. He has been around a long time, like you and me, and is on the Washington scene a great deal. I think your interest and support of the work of this committee has been exemplary, sir. I would just like to say that as I stagger off into the twilight. It is nice to see you here again.

STATEMENT OF C. LOWELL HARRISS, PROFESSOR EMERITUS OF COLUMBIA UNIVERSITY, AND EXECUTIVE DIRECTOR, ACADEMY OF POLITICAL SCIENCE

Mr. HARRISS. Thank you, Mr. Conable.

Mr. Chairman, and members of the committee, I am Lowell Harriss, professor emeritus of economics at Columbia University, and executive director of the Academy of Political Science. What I say here is personal entirely. I have a prepared statement for the record. If there is ever anything I can do to help the committee or any members, I shall be delighted to try.

A VAT can bring a lot of revenue and a VAT can work. There is experience available for implementing a VAT, as Mr. Calkins has said. By appropriate criteria for judging a revenue source, consumption taxation can be an acceptable way to finance collective activity, that is, to finance a government. It can be better than some methods used.

I agree with Mr. Calkins and a very generally held view that the concern about a VAT is that it is a money machine. Once in place, it would make easier the growth of government about whose desirability I am somewhat skeptical. Government can finance itself by taxing people on the basis of income, that is, on the basis of the worth of what they and their property produce, or on consumption, what they receive from the production of others.

The difference is net saving. For most families over most of the lifetime, the difference is not large. For equal revenue there will probably not be large differences between a broad-based consumption tax and a broad-based personal income tax.

There are several reasons for considering consumption taxation more seriously than in the past. One, of course, is that the income tax, the personal income tax and the corporate tax, bear relatively heavily on saving and for human welfare we need saving and investment, that is capital formation.

A second reason; high rates and differences in rates affect behavior in ways that are not constructive, ways that are distorting and which have adverse effects on what human beings would prefer to do.

A third reason is that income taxes do not tax all income. That is, they are not so broad as the term would indicate. And by the general criteria of fairness and equity, there are certainly defects in the income taxation.

A fourth reason I would identify is that ways now exist to mitigate the adverse personal effects of a broad-based consumption tax.

Base broadening, as you know, is in the news, Government can get more revenue or we can have lower rates on a larger base. You know, of course, how hard it is to broaden the income tax base.

Adding a new tax, a VAT, a consumption tax, would add a very broad base. Moreover, and so far as families and individuals are concerned, a VAT would not have exactly the same gaps or weaknesses as a personal income tax. That is, a VAT would tax some people on consumption out of resources on which they pay no income tax—for example, a retired person drawing on past savings or income from municipal bonds or social security benefits, or those who spend from capital gains on which rather little tax is paid.

But if there were a VAT we must expect erosion of the tax base as there has been of the income tax.

One merit of a VAT has seemed to me, and this was prominent in discussions some years ago, is that it would permit a reduction in the tax on corporate income. The corporate income tax at a rate of 46 percent is an accident of history. I will not go into it before this committee except to remind you that for most of the original period the corporate income tax was thought of, at least to a significant degree, as a way to tax the shareholder. That was eliminated rather by accident in the middle of the 1930's, the tax credit for dividends was removed. The rate went up during the Second World War temporarily, then up again during the Korean war. It has come down a little, but it is high. With State taxes the marginal rate of corporate taxation as it affects much investment must be around 50 percent, I could go on with what seems to me to be an antihumane tax, one with adverse effects on human beings.

Conceivably, a VAT could buy some significant reduction in the tax on corporate earnings. The corporate income tax imposes a high rate on a relatively small base, on the net earnings of equity capital of large corporations.

The question of regressivity of a VAT comes up and deserves serious consideration. Equity and fairness are of the utmost importance wherever coercion is used. Government in imposing taxes is coercing us, forcing people to pay. This use of power should be done in ways that meet criteria of justice, fairness.

One thing which Government should not do—something none of us want—is for government to make life more miserable for poor people, for people whose life is already miserable. We have a welfare system which reaches virtually everywhere in the country. We have ways now of mitigating the adverse human effects of any additional tax. It would be perfect, but I think the regressivity argument can be dealt with constructively, humanely.

I may add that I think our concern with regressivity is more a concern with how poor people are taxed rather than differences in the effective rates on $40,000 to $42,000 income—or consumption. The structuring of a new tax on consumption could provide offsets for poor people. That consideration can be rather different from what may have been the case 20 or 30 years go.

The bias of the income tax against saving and investment has been told to this committee more times than you can remember. It has been serious, but there has been mitigation. Many of the complexities to which Mr. Calkins referred, quite correctly, have the effect of reducing the tax burden on certain forms of saving and investment. Yet, we still have the two tier taxation of dividends. We still have a high property tax—that is not within your jurisdiction. But clearly an income does make current consumption relatively more favorable than saving to finance consumption later. There is a bias in the tax system against the kind of provisions that are required, it seems to me, to raise the levels of living the way the American people want.

A few words about a retail sales tax. I agree entirely with Mr. Calkins. The possibility of combining a Federal tax with State tax to get a uniform tax would certainly have some benefits in administration. Although such prospects would have merit, political difficulties would arise in getting uniform State and Federal retail sales taxes formidable. Retail sales taxes started out as taxes on tangible personal property, services were, and still are, not as generally taxed as I think would be appropriate for a broad-based consumption tax. Moreover, many State sales taxes still tax business purchases which in effect are for resale as part of the company's output.

Your letter of invitation suggested that I might say something about selective excise taxes. Thirty years ago we worked on this subject, and it was 20 years ago almost to the month that Chairman Mills organized a group of academicians and representatives from industry to study the three dozen selected excise taxes left over from the thirties, the Second World War, and the Korean war. It was not a good system.

Each of the taxes had defects. Trying to decide the relative necessity of one thing as against another leads to issues impossibly complex. In my paper I refer to, I believe, Representative John Dingell, Sr., who sat where you are sitting; commenting on the tax on cosmetics, he said that it seemed to him illogical to exempt the paint we put on barns and tax the paint we put on our ladies. The reason I raise this is that consideration of a VAT might invite the temptation to discriminate among types of products such as food. I submit this is not the best way to go.

The problem of low income groups should be met in other ways. Imagine the complexities. Are shoes a necessity? Of course, but what about the 15th pair? Is food a necessity? It depends partly on how much.

Selective excise taxation seems to me to have two positive potentials. One is a benefit basis as in motor fuel taxes. The other a strictly regulatory purpose, such as the tax on State banknotes from the Civil War period, it effectively eliminated the State banks from issuing currency. But there are few such cases, and and those taxes do not yield revenue.

The use of charges and prices for more Government services does have merit, but large money is not to be expected.

I comment in the paper about why I think a VAT would not really be a source of inflation.

I now come back to the fact that I think a VAT offers opportunities for improving the tax structure, but the revenue potential presents a concern which must be dealt with.

I favor the so-called balanced budget constitutional amendment. It might offer effective restraint on the growth of expenditures.

Finally, on page 10 of my statement, I cite some figures from the Advisory Commission on Intergovernmental Relations. They show public attitudes with clearly a strong preference for retail sales taxation over income tax. I have a copy of the new 1984 survey. The questions were not exactly the same, but there is no doubt that the public looks more favorably on consumption taxation than on an increase in income tax rates. I recognize the limitations of surveys of this sort, but this information may be of interest.

Finally, I differ just a little from Mr. Calkins. The personal income tax, it seems to me, is overcriticized now. For the great mass of the public who file the simple return and for whom withholding collects the tax, it is not complex. The tax does have bad features. The direction of progress, as Mr. Calkins says, is not toward more complexity. But I would not quite give up on the personal income tax.

[The prepared statement follows:]

STATEMENT OF C. LOWELL HARRISS, EXECUTIVE DIRECTOR, ACADEMY OF POLITICAL SCIENCE; PROFESSOR EMERITUS OF ECONOMICS, COLUMBIA UNIVERSITY

A Value Added Tax (VAT) could bring large revenues. Extensive experience with VATs in other countries could provide practical guides for building a structure and for effective administration. Judging by criteria appropriate for evaluating revenue sources, the VAT has much appeal compared with taxes now employed.

With large deficits in prospect and spending difficult to control, a VAT deserves series consideration. Even if there were no financial strain, it would merit consideration as a part of the continuing effort to improve the Federal revenue system. Some of the pros and cons as I see them can be indicated. The crucial and decisive elements will center on answers to the following question: How can the potentials for improving the structure of the Federal financial system be compared with the results of adding a "money machine" of formidable power, one which would facilitate the growth of government?

CONSUMPTION AS A BASE FOR FEDERAL REVENUE

Federal adoption of a VAT would be a move to consumption taxation. The finacing of collective activity (government) can come from people as consumers or from people as producers. (I simplify but not, I hope, mislead.) What we do as producers brings income; government can use that income as the measure of what we must pay for government. We consume goods and services paid for out of current income or out of savings from the past.

Income results from activities which serve others, which they value and freely pay for—what a person or his (her) property "puts into" the society. Consumption is what a person "takes out" from the production of others. Savings (positive or negative) are the difference.

For three quarters of a century the Federal government has emphasized the taxation of (the fruits of) production—income. For half a century states have relied rather heavily on the taxation of consumption.

Intuitively one might conclude that one or another base—production (income) or consumption—is generally superior. But we can go beyond intuition and seek more thorough understanding, with consumption receiving more favorable relative weighting than in the past. Four identifiable reasons can illuminate.

1. Income taxation bears more heavilly, per dollar of revenue, on savings than does consumption taxation. Capital formation serves constructively and suffers from the bias in income taxation.

2. Costs of government have risen so much that income tax rates have gotten so high and differences in rates (highest to lowest) so large that behavior is affected. The effects include many distorting, wasteful, and unproductive uses of human effort. They also undoubtedly retard net increases in production facilities.

3. What we call "income taxes" do not in fact fall on all economic income and in fact fall to unknown degree on capital (e.g., inadequate recognition of inflation) and on consumption (e.g., some portion of taxes on business). Much criticism of income taxation as it has come to exist creates powerful opposition to heavier use (to reduce

the deficit) and builds up pressure to move further in rate moderation. For more revenue, then, a base other than income seems necessary.

4. Methods available can mitigate or eliminate the burdens of consumption taxes on the needy.

Time limits prevent the listing or other reasons which help to explain why consumption as a potential Federal tax base receives apparently increasing support. The best case may not be conclusive, but it is persuasive.

BASE BROADENING—FOR RATE REDUCTION OR REVENUE EXPANSION

Discussions of income tax reform have directed attention to the significance of the breadth of the base. Enlarging the base would permit (a) rate reduction to obtain the same revenue or (b) larger receipts from the existing rates or (c) some combination. Further reduction of the highest personal income tax rates would have constructive effects. (I suggest that for this purpose "high" be considered something over 25 percent, somewhat above the average of Federal taxes as a percentage of net national income.)

Significantly broadening the present personal or corporation income tax base would involve difficulties of which members of Congress are well aware. A VAT could add a broad base. Only a "few" percentage points (say 5) might bring $100 billion a year (in 1986) on a base including food but excluding half of medical, housing, and educational expenses and all religious and welfare spending. Yet gaps in the income tax base result from kinds of forces which would continue to exist and to exert influence, "eroding" the VAT base.

A VAT rate of 10 percent should not be ruled out; with state retail sales tax rates it would not differ much from VAT rates widely used in other countries. As an additon to the personal income tax, it would eliminate the deficit—unless. The unless reflects a source of concern—the invitation to enlarge spending. Before developing this point, I must make another.

CORPORATE TAX, ESPECIALLY THE TOP MARGINAL RATE

One possible benefit from a low rate tax on consumption would be the replacement of a tax which, per dollar of revenue, must do much harm. The corporate income tax warrants more condemnation that it gets, and it deserves scarcely any of the support it has long received. Clear, logical, deliberate analysis has not been the source of the tax or of the present 46 percent rate. The reasons for condemning the taxation of corporate earnings, especially at high marginal rates, are persuasive. Taxing corporations can only reduce the ability to make economic progress. Even though average rates are lower, the marginal rates—Federal plus state—affecting decisions which involve much new investment will be around 50 percent. How did "we" come to saddle ourselves with such a thoroughly bad tax? It is anti-humane because it hurts human beings needlessly! Men, women, and children all suffer because this method of paying for government impedes economic progress—and does so by more, per dollar of revenue, than would a VAT. (A VAT rate of 4 or 5 percent would finance the abolition of the tax on corporate earnings.) The corporate income tax did not come as wisdom from "on high." It does not continue because it advances the long-run interests of Americans. An enormous amount of accident and reponses to short-run emergency have produced what we have.

A VAT with a wide base would contrast dramatically with the corporate income tax, which has as its (narrow) base the return on equity capital in the corporate sector.

The superiority of a VAT over the corporate income tax, per dollar of revenue, is great indeed.

REGRESSIVITY, EQUITY, BURDENING THE POOR

Coercion by government should not make life more miserable for those in misery. It is this conviction, I believe, which underlies much of the real sentiment which gets expressed in other forms in discussions of regressivity in tax policy. Actual dollar differences in tax burden of regressive as against proportional as against progressive taxes may or may not be large among families and individuals in essentially similar or not widely dissimilar circumstances. The money amounts count. The classification is of less human concern. Although figures cited usually apply to a single year, more relevant must be the conditions over a period of years, probably a lifetime.

Customarily, estimates relate tax to some measure of income. But perhaps consumption is more relevant (e.g., the retired family with little income but living well by drawing upon past savings). Perhaps wealth should also be taken into account. And so on.

Equity considerations are vitally important when coercion applies, i.e., when government forces the payment of tax as contrasted with conditions where decisions are voluntary. But the complexities of defining and measuring equity in alternative tax situations reinforce my belief that another focus can be helpful.

Let us look, not at differences of burdens over the entire income-wealth-consumption scale (over a lifetime) and concentrate for present purposes on the poor and near poor. Any tax that makes life worse for them will on that account be condemned. A consumption tax, a VAT, will do so. But offsets can be provided. American institutions—tax credits or refunds, the welfare system (AFDC, SSI, food stamps, etc.)—operate throughout the entire country. (The 10 percent refundable earned income credit now exists.) Relief can be granted for all or some of a VAT. There would, of course, be problems, and one does not welcome departures from simplicity. Perfection would not be expected. But this concern about consumption tax impact can be handled.

The concern for the effects of taxes on the poor and low earners requires explicit attention to another consideration. Real income depends upon production and productivity. Jobs and productivity depend significantly upon the quantity and quality of non-human capital available. The poor cannot accumulate the tens of thousands of dollars of capital now required for a job which justifies even a moderate wage. In a sense "saving for capital formation is the epitome of 'doing good for others.' "

Tax revision which increases capital formation will benefit not only those who do the additional saving and investment but also those who work with the capital equipment or who consume the products, including housing.

TAX DISCRIMINATION AGAINST SAVING AND INVESTMENT

Progress has been made in reducing the tax discriminations against owners and suppliers of capital. One can point to IRAs; Keogh Plans; ACRS which in effect allows, albeit crudely, for some of the effects of inflation on replacement cost of capital; reductions in tax on some capital gains, estate and gift tax changes. Exemption of pension plans and the "inside buildup" in life insurance has long existed.

Yet the two-tier taxation of dividends continues, as does the high marginal rate on corporate earnings. Local governments still rely heavily upon property taxation; it presents a mixed picture as regards burdening capital. The portion of the tax which falls on man-made capital, buildings and machinery, is certainly a tax burden on capital as we think of it. However, the portion which falls on land will not affect the amount of land in existence and does not have the adverse effects of the tax on man-made capital.

The income tax adds to the attraction of consuming now rather than saving to spend later. A person works, doing something useful for others, and gets rewarded. Part of what he or she receives for "doing good" is taken in taxes. Assume that he or she then decides to save an invest a portion of what remains; such action involves something more than others think is good and for which they pay in the years that follow. What is that action? It is waiting and letting others use the resources. The saver gets rewarded for this desirable—interest or dividends. More tax must be paid for the services in these years—more good for others and more tax to government. No comparable tax must be paid on the benefits from consuming in the earlier period.

A NATIONAL RETAIL SALES TAX

Retail sales taxation as used by the states offers a possible model for a new Federal tax. The tax is more open and evident than a VAT which is hidden in the price, the customary practice. Tax consciousness would be somewhat higher. Half a century ago states began taxing (for the most part) "sales of tangible personal property not for resale." These taxes are known to all of us.

The Federal government might enact a sales tax, "joining" the states. Although a Federal tax might differ somewhat from that of a state in coverage, the confusion of administration would certainly be undesirable. One can think of cooperative effort in adminstration with a minimum of additional cost of compliance and enforcement. Such potential has attractions. The necessary study could consider improving state taxes.

Yet the state taxes differ considerably. Many differences are of minor importance. Some, such as coverage (services and food), present greater problems. Definitions of "final" or "not for resale" differ, and some states in fact tax capital goods and also what they produce. State practice are not sacrosanct. The political processes of trying to negotiate general coordination might well yield constructive results, but one never knows.

At present a justified critism of state retail taxation is the extensive exclusion of services, i.e., the unequal treatment of tangible things and services. Tangible things are desired because they yield services. Taxing the purchase of tangibles but not taking services received directly discriminates among types of consumption. There is non-neutrality. The tax base is smaller than it more services were in the base.

STATE GOVERNMENT INTERESTS

In any case state officials will express concern about Federal entry into broad-based consumption taxation. They did so when a Federal VAT was being studied as a replacement for property taxation in school finance. The same reasons would apply today.

State-local objections deserve respect but in a context which has several elements. The states have no inherent or proprietary right to broad-based consumption taxes—any more than the Federal government has a comparable claim to exclusivity in income taxation. Federal adoption of a VAT or a retail sales tax would probably increase popular resistance to increases in state-local sales taxes although something would depend upon whether or not the Federal tax were a replacement for some existing levy or an addition. After many years of rising Federal grants to states and localities, a levelling off has changed the environment. State ability to pay for rising levels of services no longer get the "easy" assistance of Federal grants that existed for several years. This condition does not seem to me to be one which for the longer run should exclude greater Federal use of consumption taxation.

SELECTED EXCISE TAXES: A NOTE

Thirty years or so ago I was one who participated in general and critical criticism of the three dozen selected excises remaining from the 1930s, World War II, and the Korean War. Each had defects, and the "system" justified widespread condemnation—burdens bore haphazardly, producers were affected unequally, economic results were more easily criticized than defended, and so on. Twenty years ago—almost to the month—Chairman Mills organized testimony on the excise from academicians and industry sources. President Johnson supported the sweeping reform of 1965 (elimination for the most part). (Telephone taxation was an exception; its life has not been terminated as scheduled more than once.)

Thoughts of revenue needs will naturally turn to the potentials of selected excises. Yet I submit that progress does not lie in this direction. Unless there is a clear benefit basis (as in the motor fuels tax) or some constructive regulatory purpose will really be served by an excise tax (state bank notes were eliminated by a 10 percent Federal excise tax) the defects of selective excise taxation outweigh the merits, compared with more broadly based taxes. One point relates directly to VAT or retail sales tax possibilities. There will be proposals to discriminate on the basis of estimated degree of necessity and luxury. At best such discriminations can yield only crude results. Necessities are those goods and service which we buy "first" and luxuries those which we acquire "last" in our spending in some period. Different families have different patterns of preference.

Shoes are necessary—but not, perhaps, the fifteenth pair. Jewelry? Who would say that a wedding ring is a luxury? A girl buys, not cosmetics, but hope (It was, as I recall, Representative John Dingell, Senior, who noted years ago from where you are sitting that to him it seemed illogical to exempt paint used on barns but to tax paint used on our ladies.) Furs may not be necessary in Miami, but in Duluth conditions are different. And so on.

More extensive charging for government services, however, could have two worthwhile results. (1) Some revenue could be obtained on a rational basis related to costs of supplying and value to the user. (2) The demand for Federal spending would decline somewhat in the programs involved.

CONSUMPTION TAXES AND THE PRICE LEVEL—INFLATION

A VAT would affect consumer prices. In paying for goods and services at retail, we would be paying for more of the costs of government. The market basket is not only private market goods but also some of the services of government. A dollar would buy less of privately produced goods and services, while including something for government. Does such a difference mean that the dollar is worth less than before, i.e., that there has been inflation? Seeing the reality, one can interpret the words accordingly.

A VAT of several percentage points introduced suddenly would certainly affect most prices. Yet a change in the general level of prices—the purchasing power of the dollar—depends upon monetary factors. The worth of the dollar, to repeat, will depend upon the number of dollars relative to the goods and services (including government?) available for purchase. Inflation (rising level of prices or falling worth of the dollar) depends primarily upon the rate of money creation—of course, I simplify, but for present purposes do not, I believe, misrepresent. Addition of a VAT would not necessarily lead to more money creation and thereby to a decline in the value of the dollar.

However, if the introduction of a VAT induced an increase in the rate of money creation, (a change in) inflation could be attributed to the VAT. Otherwise, it seems to me, one should not expect inflation in a real sense—the total buying power of the dollar (including government services).

REVISION WITH A LONG-RUN PERSPECTIVE

Your recent confirming letter of invitation made more specific indications of the Committee's focus on the longer run. It arrived after I had prepared most of what appears above. My remaining time was short—while that of your interest is long.

Income—personal, not corporation—should present a tax base adequate for Federal government needs. So should consumption. For most persons and families over a period of years the two bases would not differ greatly because net savings, a chief source of difference, are not generally "large." Yet "taxable income" now excludes much of real income. Consumption as a base could start on a more complete basis and reach persons who are able to consume but who escape "adequate" tax on income—for example, consumption paid for out of interest from municipal bonds, Social Security benefits, and capital gains. Any tax base will have defects. But two—income and consumption—will not have all of the same defects. And with two used, a specified total of revenue can be obtained with lower rates and thus fewer distorting pressures on the economy and society.

Two years ago the Honorable Al Ullman presented a skillfully crafted plan at the Tax Foundation Annual Conference. I commend it to you although as I write (from home on Sunday) I cannot lay hands on a copy. The essence was to add a tax with the key characteristics of a VAT while reducing the weight of other taxes.

One objections which seems to me powerful, one noted earlier, would be the addition of a "money machine." Would it not invite the growth of government? Mr. Ullman proposed a legislative restriction on the rate of total spending increases. Such a restraining force would be weak. A constitutional limit (the so-called "balanced-budget" amendment) would be stronger but still offer only restricted restraint on the growth of government.

You know better than I the power of forces for increased Federal spending. For reasons which I find convincing, greater resistance to increases in spending would be in the general public interest.

Centralized government involves a system which imposes sacrifices while focusing on benefits. With such a bias many bad results must follow. Doing good seems so easy—with the other fellow's money. Getting something for oneself and friends at the expense of others through coercion (taxes) not through free exchange, seems to have become increasingly accepted as approvable. Specific spending programs have attractions. Our system does not match the attractions of alternatives which someone must give up to pay the costs. An additional revenue source would probably ease the process.

PUBLIC ATTITUDES

The Advisory Commission on Intergovernmental Relations has for many years presented data from surveys of public attitudes on taxes. The 1983 report shows that if additional taxes must be raised the public prefers sales taxation over income taxation by a margin of more than two to one—52 as against 24 percent for the Federal level; for additional state revenue the preference is even higher—57 to 23 percent and for local funds 45 compared with 12 percent. One must use caution in the interpretation of survey data, and the 1984 results may differ somewhat.

Convenience of payment should be noted. VAT and retail sales taxation rate high from the point of view of the taxpayer. So does collection at source of personal income tax on wages along with the short form, which the majority of filers use.

The ability to exempt exports does not seem to me to be a major consideration for present purposes. The Federal tax element in export prices through the corporate income tax is not large. Payroll taxation amounts to much more but presumably lies outside the concerns of these hearings.

Chairman Rostenkowski. Thank you, Mr. Harriss.

Mr. Conable, if you would like to start off with the questions. As we get into this, I encourage members to join in the exchanges.

Mr. Conable will inquire.

Mr. Conable. Thank you, Mr. Chairman.

There are realities and there are political realities of course, and one of the political realities in my view—I can almost promise you—is that in the enactment of a value-added tax we will not enact a simple one. We have politicized flat income tax into one of the most complex structures known to man. It is still basically a progressive tax and therefore based on ability to pay. This is viewed by the average American, if he thinks about it, as fairer than consumption taxes. He doesn't think about it much because it is a big tax. It is visible. It is therefore unpopular since taxes are unpopular.

But if you move to a comparatively invisible value-added tax perceived generally as a regressive tax, and I can assure you that the representatives of the people will politicize it by having different rates for luxuries and necessities, a la the French, by having exclusions and credits against other taxes, and in the end raising considerably less money than its potential revenue as a simple tax. If they don't do that at the outset, they will later on as we have with the flat income tax enacted in the early years of this century in the simplest form possible. I think that reality has to be considered in looking at the desirability of a value-added tax as a popular invisible politician's dream-type revenue raiser.

There are other things that can be said about value-added taxes, of course. I understand their advantages. I think you have been very honest in assessing the cost. The British experience was that it cost four times what the income tax does to administer. The French experience is that the French have learned to cheat on it, and it is no longer a self-administering tax in the view of the political scientist who thought it was.

There are lots of things that can be said about it, including the more traditional arguments about invisibility, regressivity, ease of enactment. One additional point that I would like to make about it is that I am convinced it would have to be bought from the States. It is not a sales tax but it has virtually the same impact in the view of many people. It is a sales tax enacted at every level with credits for previous taxes paid on the same product. But I have always feared for that reason that a value-added tax would be a profoundly centralizing tax in this country requiring for its enactment some assurances for the States and municipalities who have traditionally had the resource of the sales tax—reassuring them by providing that all that money flowing to Washington from the local scene, previously viewed as a resource for them, would at least be used in part to augment the flow back from the Federal Government to the local scene.

Well, I am expressing what I believe are some political realities about that. They may or not square with your view. But I think it is a mistake to view the VAT in a pure sense. It is likely to come from the hands of those who would have to enact it in considerably less than pure form, and that is the only reality I wanted to call to your attention, particularly to Mr. Calkins' attention.

I didn't mean to laugh and grimace about your statement that Congress could accept the idea of restraining its enthusiasm for a VAT tax. Once you have it in place you are correct, because it is an expensive tax to administer. The temptation to increase it is very strong because it raises large sums of money and the administrative burden doesn't go up with the tax. If you put it on at 1 to 3 percent, you have as big an administrative burden as you do if you put it on at 10 percent. That is what Margaret Thatcher found, and what any tax person would find. I suggest that to you and I was not being impolite and please forgive me. I have brooded about these things some in my role at the committee and I am sure other members have also.

Mr. CALKINS. May I comment? First, I think of a value-added tax at about a 5-percent rate at the Federal Government level. To make this practical there has to be a degree of public confidence that the rate of tax is not going to go significantly above 5 percent. It should not go significantly above 5 percent because when you add that rate to State and local sales taxes you are at 11, 12, and 13 percent. That is as high as consumption taxes are in other developed countries and as high as they ought to go. At a 5-percent rate I don't think there is the compulsion to avoidance that there is in France, where there is a VAT as high as 15 or 20 percent.

Mr. CONABLE. I think it goes to 30 percent on some luxuries.

Mr. CALKINS. I believe that a 5-percent rate on a base that included food, as Dr. Harriss suggests, would be a good idea.

Second, while I have some concern about the probability that there would be some narrowing in the VAT base as time goes on, I think it is easy to underestimate the significant change in public attitudes that is now taking place. For the 20 years from 1962 through ERTA the sentiment in Congress and in the country was that the way to get something done was to create a new tax expenditure, give us a credit for wood stoves or whatever; we can solve the social problem through the income tax. I think there has developed an awareness, which is very widespread that that process won't work, and that the process is leading to a tax which is widely seen to be unenforcible, frequently avoided, and increasingly evaded by people of modest incomes who think that, since the wealthy have so many loopholes and so many ways of getting around the tax, they ought to help themselves to their own loophole, too.

I think that attitude is now so general that we can have much more confidence in the middle and late 1980's than we could have had in earlier periods that it would be possible to enact a value-added tax with a quite broad base and defend it and not let the same kind of exceptions creep into it as crept into the income tax in the sixties and seventies. I think we have nationally learned a very important lesson.

Mr. CONABLE. Well, I don't wish to be argumentative but this is a discussion period. It has been my impression that lawyers tend to focus on shelters a great deal because it is part of their business to advise their clients about the minimizing of taxes. Therefore, they tend to overstate the effect they have had on the progressivity of the income tax. In fact, the basic Treasury figures show a progressive profile. No question about it, there is a public perception that income tax is unfair and that wealthy people don't pay any taxes. I must say—I said this yesterday and I think it is something that bears repeating—that politics deal in perceptions but legislators have to deal in realities. And so the question that we have to ask as members of the Ways and Means Committee legislating in this area, not just as advocates or the manipulators of public sentiment, one of the things we have to deal in is whether in fact the new tax is fair. Even though it is perceived to be fair, the major shift and change. Most of us on the committee know very well that no matter how enthusiastically the general principle may be viewed by the public at large, the time comes before enactment when somebody sits down and says, "Wait a minute, what does this do for me?"

And if to the average American tax reform means I am paying too much in taxes because somebody else isn't paying enough, and he figures out that on the bottom line his taxes have gone up, then as I said in several speeches lately, that is not viewed as reform. That is viewed as fraud and that is something the legislators have to look at. They have to go beyond the politics to who promotes ideas and can enjoy the ideology and the rhetoric of the campaign trail. The legislator has to sit down and say, "How is my work going to be viewed by those who are going to be concerned primarily with the bottom line and not with the rough and tumble of politics?"

Mr. CALKINS. Mr. Conable, it is for that reason I indicated that my second choice was for a combination of a Bradley-Gephardt, Kemp-Kasten type income tax reform and a value-added tax. My first choice would be to reverse the trend in the income tax and go back to an income tax for revenue only. That is my first choice for precisely the reasons that you stated. The income tax has more progressivity. People in the long run will have more confidence in the tax system if we continue to have the Federal Government rely heavily on a modestly progressive Federal income tax than we will if we broaden the base and include a VAT which will be perceived as being regressive.

Chairman ROSTENKOWSKI. You are talking about a VAT, not as just an overlay over the present system, but replacing some existing taxes?

Mr. CALKINS. One of the alternatives before Congress is to reform the income tax by lowering the rates, broadening the base and probably in the process somewhat reducing the revenue. Such a reform can be combined with a VAT or a national sales tax to make up the difference in revenue and eat into the deficit.

Another alternative is to return the income tax to an income tax for revenue only, for example by changing our current capital allowances. They are now real subsidies for capital investment. They should, instead, reflect the true cost of acquiring machinery and buildings, and in that fashion somewhat increase the yield of the present income tax.

Chairman ROSTENKOWSKI. Sitting in this chair when anybody ever suggests a value added tax, I immediately think of my predecessor. Al Ullman did have a plan for a value-added tax to replace other taxes. I thought that it was a suggestion made before its time. However, Mr. Ullman was very sincere about looking for other revenue sources. I might add that I came to this committee some 20 years ago and thought, as I sat on that lower level, that it would be wonderful to set in place a tax structure and leave it there for sometime while so that people could adjust to it and be given some certainty about the tax system.

I would much prefer to be considered as a tax-sensitive legislator revising taxes for equity reasons, as opposed to being a revenue agent. However, I am afraid that the latter is what the Ways and Means Committee has become, at least in part. We set a revenue target and then go after it. Sometimes we are very clumsy about the way we get there. I wish that some of my colleagues had been more restrained with respect to Federal spending programs, and been more economical with Federal dollars. Then, we could adjust the reserve system to achieve certain purposes, as opposed to just taxing the people and spending their money.

Mr. CONABLE. Mr. Chairman, I don't think there is any doubt that future tax changes are for at least the foreseeable future likely to be driven fiscally and not to be efforts to reform for the sake of reform.

Chairman ROSTENKOWSKI. I would like to disagree with that, but I am afraid that that is true.

Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

I want to ask the panel a number of opening threshold questions. Do you both believe that there is a need to raise revenue?

Mr. HARRISS. Yes, with reservations. Yes, I think so, given the propensity of our lawmakers to spend, I think some additional revenue is needed.

Mr. DOWNEY. Did you say that in light of the budget deficits we face or in light of our proclivity to spend? I think you have answered the second part. I am a little concerned about the first.

Mr. HARRISS. I think the deficit is clearly too large. Even though there are projections that with optimistic growth the deficit can be more or less automatically reduced I am not so optimistic. There is something called compound interest, and it adds up. We do not have to look very far into the nineties to see a really very serious interest bill. So I think that more revenue is needed now. I do wish that expenditures would be reduced, but let me just underscore, I am very sympathetic with the problems you face. A couple of years ago when the reduction in Federal aid to college students was being considered, I found myself on the side of the spending.

Mr. DOWNEY. Well, you weren't alone.

Mr. Calkins, I know you are not—I don't know if you are not——

Mr. CALKINS. In my view, Mr. Downey, a Federal deficit in a time of prosperity of 4 or 5 percent of the gross national product is absolutely unacceptable. Even if Congress were able to reduce expenditures to the maximum degree I could consider desirable, we would still need some additional revenue to close that deficit.

Mr. DOWNEY. I think part of the debate we are going to have is a broader question of whether or not we can have both a dynamic economy and a just society. I have always believed that the principle that I learned on this committee, that we should try and do things that are equitable, simple and neutral, the hallmarks of good tax policy. But I think one of the broader questions that we are going to face in the next Congress is one of whether or not we can have equity and growth, whether or not there shouldn't be a sacrifice that we pay for equity to have growth. I firmly believe, and I am certainly not going to prejudice your answers, but I believe you can have equity and growth.

I would like you to comment if you could on this notion that somehow our pursuit to be equitable—and in the past we have redistributed income through Social Security and we also do it through the Tax Code—whether or not that has helped us or hurt us, No. 1. And No. 2, whether or not we can achieve greater growth by not being equitable. I guess they are basically variants of the same question.

Mr. HARRISS. You raise issues of fundamental importance and exceedingly great difficulty. It is always tempting to think you can do good with the other fellow's money, and we have now two decades or more of experience. From that I think we should be able to learn more than at least I know yet about what kinds of programs are effective and what kinds of programs are disappointing and harmful. The premium which AFDC aid for dependent children puts on breaking up families seems to me utterly deplorable.

It is not easy, however, to know what is the best balance between redistribution and emphasis upon alternatives to encourage progress in growth and expansion. I will be very humble in trying to suggest specific things. In general, certainly, capital formation over time has been a major contributor to the raising of the levels of living. A poor person cannot accumulate the capital that is needed for his or her job. Someone else has to do it. If a job requires $30,000 of capital facilities to provide a more or less modest income now, someone else has to accumulate it. It is not something that the person can do for himself.

Mr. DOWNEY. Professor Harriss, can I ask you on the question of accumulation of capital, my experience, and it is limited in some of the reports that I have read, is that it is pretty hard to judge just what countries do to generate capital formation simply on the question of taxes. For instance, the British have the lowest rate of taxation on capital formation, yet they also have the lowest rate of capital formation. And the Germans have had one of the highest, the West Germans. So it has always appeared to me that there is a lot more to it than just taxation. You can fix the tax at any level, but there are other social policies that have to do with raising formation capital than just taxation, would you agree with that?

Mr. HARRISS. Yes, I agree, the relationships are complex. Any complete discussion would take us much beyond the issues of today's topic. The tax system I think has borne with undue severity on savings, on capital formation, but the true magnitudes, especially of the net results, are unknown. The picture is certainly not clear.

Mr. DOWNEY. Mr. Calkins, let me try and hone in on this. Can we have a dynamic economy and a just tax system, a progressive tax system in your view?

Mr. CALKINS. Yes. In my view, the way a tax system can best contribute to economic growth is by being both predictable and evenhanded. Our current system is not predictable because we are constantly changing it. It is not evenhanded because certain industries pay taxes—as Mr. Harriss pointed out—at 50 percent of their income, while other industries effectively pay no tax on their income. There is no sense to that. It cannot contribute to economic growth to have a significant share of the revenues of this country raised in a somewhat—well, in a very unequal and hard-to-rationalize fashion.

I disagree a little bit with Mr. Conable. Perhaps I am just standing up for the legal profession, but I think tax lawyers in many ways have a better view of how the world really works than, I should say with deference to my colleague, some economists. We see the extent to which people shape their affairs to achieve tax results. That can't be good economics; it can't be sound business. It does not make sense. We clearly should move away from such a large patchwork of incentives that nearly everything is incented in our present tax law. We should come to a tax in which we don't raise revenue by tinkering with the tax base. Instead; we should raise revenue by tinkering with the tax rates. We should change the base seldom and only when the change will improve the fairness and efficiency of the tax. We need a 20-year effort to get a good income tax, good in the sense that it taxes everybody in a reasonable and predictable fashion and deals with the very complicated problems of time value of money in a reasonable manner. Then when Congress needs more revenue, it can increase the rate. Congress would no longer narrow the base to reduce receipts or expand the base to increase receipts. There ought to be a constant base with fluctuating rates.

Mr. **Downey**. I thank you both.

Let me ask you a hypothetical. If we could turn the tax clock to 1954 and have the 1954 code without the changes in the last 30 years, does that strike you as a reasonable thing to do?

Mr. **Calkins**. Yes. If you would read the committee reports up until 1962, you will find that Congress devoted itself year after year to raising revenue fairly. Every committee report from 1913, through the 1980 Revenue Act is basically focused on the question, how do you raise revenue fairly? Only in 1962 when President Kennedy wanted to get the country going again, and somebody hit on the investment credit as the best way to do it, did we really start down the slippery chute of inventing incentives to achieve economic results. From 1962 through ERTA, which was the high water mark for use of tax incentives to affect the economy, we made things worse and worse year after year. Now we know we have ourselves in a terrible pickle and we have got to get out.

Mr. **Conable**. Will the gentleman yield?

Mr. **Downey**. Yes.

Mr. **Conable**. Have there been no improvements since 1954?

Mr. **Calkins**. There is always an exception to any statement. Clearly, there have been some improvements.

Mr. **Conable**. Do you think we should tax foreign income at all?

Mr. **Calkins**. I think we should tax foreign income.

Mr. **Conable**. Well, we did not.

Mr. **Calkins**. I will defer on that. I was under the impression that we did tax foreign income.

Mr. **Conable**. Straddles, do you think we ought to tax them?

Mr. **Calkins**. Oh, yes.

Mr. **Conable**. Do you think we ought to tax them? We didn't. Tax-exempt leasing deals?

Mr. **Calkins**. No, I am opposed to them. Most industrial revenue bonds are a bad idea, a terribly expensive subsidy. If we want to encourage municipal construction of various kinds, there are much better ways to do it.

Mr. **Conable**. Do you think we are going to uninvent tax-exempts—like a nuclear bomb?

Mr. **Calkins**. I think that the municipalities and States of this country are paying 2 or 3 percent more for their borrowed money because we have allowed about half the tax-exempt market to be taken up by people who are essentially in private business. If I were a mayor or a Governor, I would be very unhappy about that and would be coming to you and saying, "Why don't you do something about it, please?"

Mr. **Conable**. One of the impressions we have on this committee is that we have to move very fast and frequently to keep up with the fertile minds out there in the legal community who are finding ways to make de facto changes, which we then try to meet in some de jure fashion. We are part of a very dynamic society, and there are a lot of extremely intelligent people pressing the state of the art, and thus, bringing us frequently face to face with loopholes which were not even dreamed up of 10 years ago.

I acknowledge, there is some element involved there of the use of complexity for private purposes.

Mr. **Calkins**. My criticism of our present tax law is not directed at the provisions which are attempting to close the loopholes, and deal with the complicated problems of time value of money, shifting of economic interests among partners, and the rest.

My criticism is directed to the basic incentive provisions that make those loopholes possible. If you will provide a tax system, as we now do, in which you can make money by combining an investment credit and rapid depreciation, you have an irresistible temptation to partnership allocations, leasing devices, and the rest.

The cure is to go to a rational system of capital allowances, which resembles what an accountant thinks is the proper rate of depreciation. If we do that, we will take away the pressure which creates the loopholes.

As long as the economic pressure is there, I will devote the portion of my working life, when I am not testifying to Congress, to helping my clients figure out how best to adjust their affairs to take advantage of the opportunities.

But, for the public portion of my life, I will urge Congress to remove the opportunities.

Mr. **Downey**. Thank you very much, gentlemen. Thank you, Mr. Calkins, I think we share a very similar outlook on what we should be doing.

The irony of the mayor or the county executive or Governor coming to the Congress and asking for industrial revenue bonds to be reduced is not lost on us, since not one of them has ever so testified.

They all come and say, keep them open, make them available. Let's have this open-ended entitlement system, because it produces jobs and on and on.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Pease will inquire.

Mr. **Pease**. Thank you very much, Mr. Chairman.

I would like to welcome both of our witnesses, and in particular Mr. Calkins, who has a long and distinguished history of providing private-sector advice to public agencies, both at the State level in Ohio and at the Federal level.

I think the testimony of both of you gentlemen, has been very helpful this morning. It has helped to convince me to increase my skepticism about the so-called virtues of a value-added tax.

It occurs to me that what you have outlined is a very complex, new system of taxation, under the best of circumstances, and we hardly ever legislate under the best of circumstances.

It seems to me the potential for Congress to take what is fundamentally a complex system and add on an enormous amount of additional complexity is irresistible.

I don't know how we can avoid that. I am particularly grateful for your comments on the progressivity problem. You say that ways exist to ameliorate the shortcomings of a value-added tax with respect to progressivity.

I would like to know how this could be achieved. But first I would like to ask you how would you go about ameliorating the progressivity problems of a value-added tax?

Mr. **Harriss**. One possibility is that which some States use with their sales taxes. They refund at the end of the year a sum which is the presumed amount of the tax paid or the equivalent of some personal exemption; that is, 5 percent on $1,000 of purchases or some such amount.

Another possibility is to increase the welfare grants such as AFDC, SSI, and means-tested benefits to offset the estimated addition of a value-added tax.

The earned income credit, which applies to married men up to a maximum of $500, offers another exemption.

None of these systems can be absolutely foolproof. Sometimes the persons in most need will be the least able to file a return and comply. This unfortunate group does exist, but I would think that we have an administrative organization that can deal with the great majority of those cases. Some kind of a refund of the estimated value-added tax paid by lower-income groups could serve.

Mr. **Pease**. We often talk about progressivity. We look at the difference, if you divide all taxpayers into quintiles, between the top quintile and the bottom quintile. What you are suggesting are ways to take care of the bottom quintile.

What about the differences among the top quintile and second and third quintiles?

Mr. **Harriss**. I don't worry about them. The dollar amounts of any apparent inequities spread over most of a lifetime will not be very great. The family with $90,000 income or more in wealth or consumption will pay more tax under a regressive tax than the family with less than $90,000.

Both of them will pay quite a bit of VAT. Differences in the upper end of the income scale will be of less concern that the obsolete amounts. I think a personal income tax is better. I think progressivity is desirable, but the departures from reasonable progressivity that would come with a VAT, would be modest.

Let's assume a 5-percent rate, although a rate higher than 5 percent seems probable. Spread over a period of years, the differences would be relatively small from one group to another. They would not seem to me to be very important.

Always the person spending more will be paying more tax than the person spending less.

Mr. Calkins. The best figures that we could find when we did our study in the early 1970's would say that, if we were to impose a 5-percent VAT in this country now, yielding $50 billion, the burden of the tax in the highest quintile would be 0.7 percent. In the lowest quintile, would be 1.9 percent. In the ninth quintile, would be 1.1 percent, 50 percent higher than in the top quintiles.

The magnitude of that tax is large enough that I would be concerned about the difference between the impact in the highest quintile and the quintiles below it.

I think it is clear that the fairness of our tax system would be reduced by a significant shift of the weighting away from income taxes toward a value-added tax, if you assume, as I do, that there ought to be some material progressivity in our tax system as a whole.

When you look at our tax system as a whole, there is some progressivity in it now, but not a great deal, because the progressivity of the Federal income tax tends to be offset by the generally regressive nature of the property and sales taxes at the State levels, and of course, by the Social Security tax.

Mr. Pease. Well, thank you.

For the record, whenever I view proposals like the VAT, I think of them in terms of not only theoretically what can be done, but in actuality, what is likely to occur in the Congress. Mr. Harriss, your proposal to offset the progressivity of the VAT by increasing AFDC payments for poor families, for example, strikes me as being in the realm of ~~not~~ being likely to happen in the Congress.

I am afraid we would wind up with a VAT which would increase the tax burden on the lowest quintile and we would be unable to accomplish the offsetting increase in direct governmental transfer payments to households in that group.

Your first choice is to return the Federal income tax to its original form, and not bother with the VAT. Your second choice is to have a capped VAT and a reformed income tax with lower rates and a broadened base.

If one were unable to achieve the second part of the program—the reformed income tax—what would be your position concerning the imposition of a VAT on top of the existing income tax structure?

Mr. Calkins. I would not favor it. I think it is a complicated new additional tax. I don't think we need it to achieve the additional revenues required to close our present budget gap, in the absence of some significant reform of the income tax, which would tend to stabilize or reduce its revenues.

Mr. Pease. Your third possibility, which you warn strongly against, is continued efforts to close loopholes and remove unintended benefits from the Tax Code.

Mr. **Calkins**. Without changing the fundamental nature of the code. That is, I distinguish between the third alternative, which I do not favor, and the first one, which I do, because the first one goes at the basic incentive provisions in the code and takes them out, whereas, the third one, the one I do not favor, leaves the incentives in and then attempts to erect a whole series of barriers to their use. That is what I think is causing our complexity and the impressions of widespread avoidance and the like.

Mr. **Pease**. You must not have been terribly happy with the tax bill that we passed in 1984?

Mr. **Calkins**. It shows to me a very important change of course, because through ERTA, Congress was constantly making the tax law worse by adding more and more incentives. Starting on with TEFRA, and the 1984 act, Congress has moved in the right direction.

I hope Congress has learned from that lesson, that the difficulty of erecting barriers to loopholes, while leaving the basic incentives in the law, is so great, that it is not a practical or desirable course to continue. Therefore, I am hopeful that the lesson of TEFRA and DEFRA is that one has to address the basic incentive provisions that are in the law, the basic tax expenditure provisions, and deal with them and not simply try to curb their use while leaving them there.

Mr. **Pease**. I think in that connection, the chairman of the committee deserves a great deal of credit for that reversal, and it is largely due to his personal efforts that Congress in the last couple of years has not added to tax expenditures, and has made some modest efforts to reduce them.

Mr. **Calkins**. It is very important that my position and the position of others who think like me be correctly perceived. We are not critical of the loophole-closing efforts of the recent Tax Reform Act of 1984. What we are critical of is the fact that the approach is to confine the use of incentives, which are allowed to continue, rather than to go at the problem by reducing and eliminating the incentives.

Mr. **Pease**. That is a useful differentiation and I presume that you would not feel so strongly about attempts by Congress, even if they were piecemeal, to eliminate loopholes as opposed to juggling them around?

Mr. **Calkins**. Not at all. I would encourage it. That is what we ought to do, and that is what I said in my recent article.

Mr. **Pease**. We received testimony the day before yesterday from Henry Kaufman and others that it is imperative that Congress act as early as possible in 1985 to reduce the deficit.

They think that waiting until the end of 1985 or longer would be to court real disaster. That being true, and knowing the legislative process as I do, I am not optimistic that we will either reform and redirect the current income tax system or adopt a VAT system in that period of time.

I would like each of you to comment on two possibilities for raising a good deal of revenue in a short period of time.

One is a suggestion that rather than alter the tax picture in the near term, we adopt a percentage reduction so that every tax expenditure would be worth 90 or 80 percent of its former self. Considering that tax expenditures will cost us about $400 billion in revenue, this option could raise significant amounts of money.

The other suggestion is to increase emphasis on tax compliance. Some people think a lot of money is recoverable, if the IRS were to be given the resources to improve enforcement.

Would both of you comment on that?

Mr. HARRISS. So far as the tax expenditures are concerned, one would almost need to look through the list. The things that are classed as tax expenditures include an enormous variety of items.

Some of them could certainly be cut by a tenth or something like that, as not a bad thing in a world where difficult decisions have to be made. But I would not want to make a general, sweeping statement.

The other alternative was what?

Mr. PEASE. Increased tax compliance.

Mr. HARRISS. Certainly increased tax compliance does involve, I am told, significant amounts of money, but nothing in the $40 billion range, at least to the best of my knowledge.

Anything that can reasonably be done, I think, should be done. I think more should be spent on administration. I was told not long ago by a former Commissioner of the Internal Revenue that the amount taxes uncollected, due to lack of followup is large. The figure of $6 billion comes to mind.

The collection process is adequate. There is useful money here, but not of the totals needed.

Chairman ROSTENKOWSKI. We have had a terrible time trying to increase appropriations for IRS resources. We have been unable to get any increases passed through Congress.

This Congress has no control over that. However, every time it is considered in the appropriations process, Congress votes it down.

Mr. CALKINS. I would prefer a 10-percent reduction in tax expenditures to an equivalent percentage surcharge on the tax. That would be a better way to achieve a result simply.

Mr. CONABLE. Which tax expenditures, across the board?

Mr. CALKINS. Across the board. With respect to compliance, I do think we can get another $50 billion out of compliance, but it will take 10 years to do it, and a lot more appropriations for revenue agents and the like. It is a long-term cure, but it can be achieved if we work at it.

Mr. CONABLE. The 10-percent reduction complicates the tax further?

Mr. CALKINS. I do.

Chairman ROSTENKOWSKI. Gentlemen, thank you very much for joining us this morning.

Mr. CALKINS. Thank you for having us.

Chairman ROSTENKOWSKI. The Chair calls Gerard Brannon. Thank you for joining us this morning. We are happy to have you share your thoughts with us.

STATEMENT OF GERARD M. BRANNON, DIRECTOR OF SPECIAL PROJECTS, AMERICAN COUNCIL OF LIFE INSURANCE (FORMERLY DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX ANALYSIS)

Mr. BRANNON. I want to make clear that I am appearing here as an individual, and in no sense do I testify in behalf of the life insurance industry.

I presume I was invited on this particular topic of energy taxes because I researched and wrote on energy taxes in the 1970's.

In the 1980's, I have turned my attention to other tax matters and largely ignored this old love. I accepted your invitation on the grounds that I think some general tax principles are appropriate to these immediate questions, and that might be as important as some of the refined points as energy technology, which I have forgotten in the last 7 years.

I would like to comment on three specific kinds of energy taxes and also extend these comments to the general matters of consumption taxes, because the two are closely related.

The first thing I wanted to mention was a general tax on energy as a way of raising revenue. This is in many respects like a general consumption tax in the sense that it is an attempt to raise new revenue.

Unfortunately, it does not limit itself to consumption, so that it gets partly away from the problem we have in our tax system.

And I think, for several reasons, it is inferior to a general consumption tax, such as a VAT or a retail sales tax.

Any tax distorts decisions in the private economy. Our central problem in tax policy in these days is that the income tax is perceived to distort decisions between consumption and savings, and that is why we talk about a tax more explicitly on consumption.

The general energy tax wouldn't be explicitly on consumption and to the extent it does tax consumption, it introduces new distortions and inefficiencies between one kind of consumption and another, and it impacts on certain kinds of capital formation, exports and so forth.

It somewhat highlights my opposition to a general energy tax to admit that there are some particular problems associated with energy sources, pollution and so forth, that might very well be handled by the tax route, such as through antipollution taxes.

The structure of those taxes, however, should be that they would disappear as the pollution disappears and would not really serve as a revenue source.

The next energy tax that I would mention is a tax on oil, ether, particularly on imported oil and/or imported gas. One way of thinking about that sort of a tax would be to ask how it would work as the world oil price fluctuates.

At a period when the world oil price is high, which might very well help if there is another upset in some Middle Eastern countries, it would be not very sensible for us to have a tax which further increases the oil price of the United States.

All of our big inflation problems in the late seventies were triggered by the high oil price income after Iran, and to make that sort of a problem even worse, rising prices, wages, trying to catch up to the rising prices and so forth is not a very sensible thing to do.

How would the oil price work when the world oil price was very low? The ideal situation is for us to buy more oil when the world oil price is low and essentially send a signal to the producer countries that they get some advantage from cutting their price, and in effect, we raise the price when the oil is low, we send them the signal to keep the cartel going and keep the price up.

So that, just that sort of argument would suggest to me that there is no particular advantage in our trying to artificially increase the oil import price.

There are obviously other disadvantages connected with all of the inefficiencies messing around which market prices imply.

Finally, on the energy tax matter, I would like to say a little bit about the matter of the windfall profits tax. This is really in substance a tax on profits, even though it is in the form of an excise tax.

This oil price situation is one where the import price dictates the domestic price and consequently, an excise tax imposed on some domestic producers doesn't get passed on in the price in the way other excise taxes do.

It really falls on profits.

The next thing I want to say about the windfall profits tax is that it does relate to a very serious political problem that you have, whenever a major price changes.

Nowadays many conservatives speak with horror at the liberal notion that high foreign oil prices create positive windfall profits for domestic producers, profits the Government should recapture by a windfall profits tax.

A few years ago, liberals spoke with horror at the conservative notion that low foreign prices created negative windfall losses for U.S. producers that required the U.S. Government to get involved in various price control measures such as import quotas and supported State rationing and so forth.

Neither side is "holier than thou" when it comes to a change in price. Society doesn't like it. Conceding that these big price changes are serious political problems, I would like to say that these kinds of knee-jerk reactions of price control or import quotas are a very bad way to deal with your political problem.

The trouble with price control is clear, when you think about it as a combination of two policies. It amounts to 100 percent windfall profits tax so far as the producer is concerned.

Anything above the control price does not go to the producer, and simultaneously, it amounts to a subsidy to consumers. That price he could have gotten which you are taking away from him, you make cheaper to the consumer.

You tell the consumer in the oil case the more oil you buy, the more subsidy you get. Congress did realize the hopelessness of oil price controls in the seventies, and it got around to the task of trying to separate these two price control things more rationally by trying to devise less than 100 percent windfall profits tax on producers, and by introducing a selective system of assistance payments for those consumers who were seriously hurt by price increases.

This gets me around to my specific topic of the windfall profits tax on oil. The slow buildup was because I used to be a congressional staff person.

I could very well tell you that petroleum markets would work better without any windfall profits tax, but I realize you have that political problem that is associated with any sharp price change, and I think that the advice would be fruitless to you.

Now, there is another reason for my not dumping on the windfall profits tax on oil. The fact of the matter is that any tax that you impose will have impacts on producers, as well as consumers, and any serious approach to this whole supply-side problem of taxes doesn't lead you to screaming, let's get rid of all taxes.

Sensibly, it leads you to asking what kind of taxes have less impact on supply than other kinds of taxes. There is a long history in public finance of looking for these kinds of taxes that have less impact on supply.

From that standpoint, a windfall profits tax on existing oil has a certain initial appeal. Certainly, many of the output decisions in an ongoing oil well are going to go on as they would, whether or not this is a tax, so it might very well be that this tax has less supply side impact than, say, a general corporation income tax or increase in the corporation income tax to bring in the same revenue.

Whether or not this is the case, I tell you frankly, I don't know. I have been away from this field, and it has struck me that there has been very little systematic research on precisely how this windfall profits tax on oil has worked.

I would urge you to see to it that such research is done, even requesting the Treasury or the joint committee staff to do a really large-scale job on understanding that tax.

The tax will likely be considered for extension. One contribution I would like to make to that is, I think the form in which you structured the tax probably increases the supply effect, the discouragement of output, particularly the fixed termination date.

It is important in the mineral technology to decide when to exploit a particular resource, when to introduce secondary recovery, when to do various other things to increase output.

In effect, you sent the signal to the industry, if you have any opportunity to postpone consumption, the profits will be better later on. You encouraged them to postpone and increased the impact of this tax on discouraging output.

An alternative would have been to more or less calculate the expected future output from existing wells with normal production technology as of the date this tax went into effect, and tell each oil owner that this much is going to be subject to the windfall profits tax.

If you produce that faster, you will get through the taxed amount, and then you have free opportunity to get further profit from secondary, tertiary recovery, and so forth. If you drag it out, the tax will last longer than 10 years.

That whole delay problem is a serious problem in the windfall profits tax, and is one that deserves a good deal of study.

The other thing I would like to do is to comment briefly on our general consumption tax problem, this in light of the discussion that I heard this morning and yesterday.

I would summarize my reaction by first saying that under the present system the bulk of our revenue comes from an income tax which in many ways is comfortable for us.

We have over the years made a lot of adjustments in the income tax, to deal with family size, to introduce some progress and so forth, that society thinks of as fair.

While we were doing this, we became aware of this whole investment savings problem, and we have over the last 20 years done a great deal to convert that income tax into an expenditure tax, the kind of thing that David Bradford, Harvey Galper, Henry Aaron spoke of yesterday.

This was the introduction of a lot of things to remove tax from particular kind of savings investment. It is very close to the expenditure and tax treatment of investment.

IRA's are another kind of expenditure tax treatment. All of that would be automatic if you followed the ideas of the gentlemen I mentioned.

While you have compromised between the income tax and the expenditure tax ideas, you have created a very uncomfortable halfway house.

One more thing, you introduced great distortions between various kinds of savings. Some savings get the break. Others don't.

The other real serious problem in this halfway house is that you still have an unlimited interest deduction, so that people can qualify for these savings incentives by going out and borrowing the money. That is what tax shelter problems are all about.

These things keep cropping up in new forms and trying to juggle this combination of borrowing and saving incentives makes the income tax very uncomfortable for you, and I think that is very much what Mr. Calkins was talking about.

A lot of this emphasis on savings investment incentives came in after the seventies, and you found that you were continuously plugging new holes in the dike.

Now, many experts were giving a different advice from Mr. Calkins', which was to go consistently to a consumption tax. This is basically David Bradford's program yesterday, and Galper and Aaron developed the same thing.

There was much difference of opinion from this. Many experts insisted that this wouldn't work, that the transitions were enormous and just on the basis of the fact that there is so much division within the tax profession, it seems to me out of the question that you should suddenly have this drastic change.

You have the problems between the halfway house that we created, income tax and consumption tax. That is a problem, and that is why it is so hard for you to get out of this by changing the income tax, particularly the interest deduction thing is what you find so hard to change.

That suggests to me that the answer is to deal with the serious revenue problem that you have by some direct consumption tax that would go in addition to the income tax.

This could be a value-added tax or a retail sales tax. It gets away from the halfway house problems that you got in the income tax, and it can be conformed to our prevailing ideas of fairness and progressivity.

The basic step to make the VAT or retail sales tax fair would be to use the refund procedure that Professor Harriss talked about.

In that connection, I would like to submit for the record a copy of an article that I wrote recently for the National Tax Journal that deals specifically with these problems of a VAT and the way in which they might be addressed.

Chairman **Rostenkowski**. Without objection.

Mr. **Brannon**. Thank you. That is all I have to say.

[The prepared statement and attachment follow:]

STATEMENT OF GERARD M. BRANNON, DIRECTOR OF SPECIAL PROJECTS, AMERICAN COUNCIL OF LIFE INSURANCE

I want to make clear that I testify as an individual. I presume I was invited on this topic because I researched and wrote on energy taxes in the 1970's. In the 1980's, I turned my attention to other tax matters, largely ignoring my old love.

I accepted your invitation on the grounds that some general tax principles are as relevant to your decisions as some refined points of energy technology that I have probably forgotten.

I will comment on three kinds of energy tax.

A GENERAL ENERGY TAX

My first specific is a general, revenue raising tax on all energy sources. Such a tax would be designed to achieve a uniform rate of tax to the average price of energy in BTU's from various sources, as sold for final demand.

I agree that new revenue is important for the U.S. government and that one can make a good case that the additional tax should fall on consumption. A general energy tax is vastly inferior to a broad based consumption tax or a value added tax. (If you do not want to concentrate the new tax on consumption, you would simply increase revenue from the income tax and the energy tax question would not arise.)

Any tax will distort some decisions in the private economy. The case for a general consumption tax is that the present tax system distorts decisions against private saving and investment and that this distortion can be offset by introducing a general consumption tax. Taxing energy consumption relative to non-energy simply introduces new distortion and inefficiency.

It highlights my opposition to a general energy tax to concede that there are particular external, or social costs associated with various domestic energy sources, such as sulfur from coal, or radioactivity from nuclear energy, etc. Government policy should impose specific costs on the production of energy from these sources by way of regulations or pollution taxes. These policies should be structured to solve the pollution problem. As coal becomes clean, say by stack gas treatment, this reason for imposing a tax on coal disappears. There is no reason whatever for a selective tax which falls on clean energy sources. These in fact we are subsidizing.

AN OIL IMPORT TAX

The next tax I would mention is one on imported oil and/or gas. One way to think about this is to focus on the fact that the world oil price has been and will be erratic depending on wars in the Middle East, the state of OPEC cooperation, etc.

When the world oil price is at a relatively high level, as it was after the Iranian revolution, it does not seem sensible to make the price even higher in the U.S. It was that surge in oil prices that had so much to do with the double digit inflation in the late 1970's.

When the world oil price is at a relatively low level, it still does not seem to me sensible to make the price higher in the U.S. The appropriate signal to send to OPEC when prices are low is that we will buy more. To the extent that we keep the price high in such a circumstance we hold down sales and send the message to OPEC that cutting their price is a bad strategy for them. We should encourage OPEC to cut price.

WINDFALL PROFITS TAX

Next, I want to say a number of things about the windfall profits tax (WPT). In the first place, although this is in the legal form of an excise tax, it is much more of a profits tax because imported oil sets the market price of oil in the U.S. An excise type tax on some U.S. output is not shifted into a higher price; it comes out of the gross return available to the U.S. producer, i.e., out of profit.

The next thing to say about WPT is that one must think about it in conjunction with the political problem of price control. Sharp changes in important prices are serious political problems. Nowadays, many "conservatives" speak with horror at the "liberal" notion that high foreign oil prices create positive windfall profits for domestic producers' profits that government should eliminate by price control or taxes. Not so long ago "liberals" spoke with horror about the "conservative" notion that low foreign oil prices created negative windfall profits, i.e., windfall losses for domestic producers that government should eliminate by a form of price control, import quotas. Neither side is "holier than thou".

Despite conceding that sharp changes in important prices are serious political problems, it is even more important to recognize that the knee jerk reactions of import restrictions and price controls are very bad ways to deal with the problems.

The trouble with price control is clear when you think about it as a combination of two policies: a 100% windfall profits tax on producers (the producer retains nothing over the price ceiling); and simultaneously a subsidy to consumers (consumers get the product at less than replacement costs).

With respect to petroleum, the Congress took far too long in the 1970's to realize the hopelessness of oil price controls. Eventually it got around to trying to replace price control with more appropriate policies, a less than 100% windfall profits tax on producers and a selective system of fuel assistance payments for those consumers who were seriously hurt by the price increase.

With some delay, I have gotten to the specific concern of this Committee, the WPT on oil. The slow build-up was because I used to be a Congressional Committee staff person. I could tell you that petroleum markets would work better without any WPT but I also realize that you have political problems that make such advice fruitless. (If that were not the case, the Congress could have fully decontrolled natural gas a long time ago).

There is one other reason for my not dumping on the WPT on oil. The fact of the matter is that any tax will have some effect on producers and consumers. A serious approach to recognizing the supply-side of economics does not lead to idiotic slogans to cut all taxes every where but to efforts to find taxes which have less effects on supply than other taxes. This is a very old tradition in public finance going back at least to the single-taxers behind Henry George and coming up the very sophisticated optimum-tax literature in the professional journals since the 1960's.

From a supply side view point, a WPT has great potential. Once an oil or gas well is developed, many, not all but many, output decisions will flow automatically without regard to the marginal profit after tax. If this special tax base can be identified, taxing it can potentially interfere with supply less than collecting an equivalent tax from say corporations generally.

All I have made here are the points that a WPT on oil has a political function and also that it has a potential economic role. Now I have to admit my practical shortcomings from being out of petroleum tax research for the last six years. I don't know how well the specific WPT that you enacted in the late 1970's fulfills this potential economic role. I am not aware of any serious research effort to find exactly how the WPT has worked.

If I am right that sharp price changes are a serious political problem, it is important that you direct some serious research into finding out how WPT has worked and more important how it could be improved so as to fall more exclusively on windfalls and have less effect on output, or whether it should be allowed to lapse.

Contributing to that research, I offer the opinion that one serious error in design in the WPT that you adopted was the termination provision. In the technology of mineral development a very big question is "When?" Usually we know about where the stuff is and how to get it, and the business decision is when to move. The present design of WPT makes it more attractive to postpone production, to postpone secondary recovery, etc. I think you could have designed things differently. You could have specified for each well in operation at a given date an expected amount of future production with normal technology and said that much oil production would be subject to WPT whenever it was produced. If producers introduced special recovery techniques one could get the benefit by running through the taxable output earlier and enjoy zero tax on extra output. In this design, postponing output is not rewarded by tax avoidance.

I do not claim that this alternative solves the problem that WPT encourages postponing output. I have elaborated the point simply because of my earlier arguments that WPT does deal with serious matters and probably the present form of WPT involves an excessive interference with petroleum output. You really should learn from this experience. This is the important time for serious research on WPT, especially before it comes up for renewal.

CONSUMPTION TAXES

Finally, I would like to add a few comments on consumption taxes in general as a response to the current revenue need.

1. The bulk of our general revenue comes from an income tax which by and large has been adapted to the ideas of fairness prevailing in the public. (It is moderately progressive, recognizes family size, etc.)
2. To deal with economic problems, the income tax has been converted part way into a consumption tax by adding tax-relief for many, but not all forms of saving.
3. This half-way house form of tax is not very satisfactory because some forms of savings are helped more than others, the unlimited interest deduction permits tax reliefs for unreal savings, i.e., those financed by borrowing.
4. Many experts are advising you to get out of this mess by converting the present half-way tax into a pure consumption tax which could then be adapted to the prevailing ideas of fairness. The experts are not near unanimity on this and I don't think you are ready for this drastic change.
5. The internal inconsistencies in the present income tax, such as the interest deduction, are such that I don't expect you to change them, but leaving them there makes it hard to simply increase income tax rates.

This in a nutshell is your problem. Now for the answer.

6. A direct consumption tax, such as a value added tax, VAT, or a retail sales tax, RST, can be designed to provide a more efficient compromise between the income tax and consumption tax principle and be conformed to the prevailing ideas of fairness that makes our income tax acceptable.
7. The important step to make VAT or RST fair is to provide a refund of the amount of tax that would be paid on a poverty level of consumption, which is broadly the level of income tax personal exemptions plus zero bracket amounts. A food exemption is a very unsatisfactory way to deal with the regressivity of VAT.
8. I would like to submit for the record a copy of an article that will be published in the National Tax Journal. This article addresses quite specifically a number of objections that have been raised to a value added tax and suggests how to meet them.

THE VALUE ADDED TAX IS A GOOD UTILITY INFIELDER

In baseball, the world champion Baltimore Orioles have a reputation for getting the most out of players with limited ability, who more than adequately fill specific roles at specific times. This is the kind of argument I make for the value added tax (VAT).

I won't debate whether VAT belongs on an All-Star Tax Team. I do argue that it would be a valuable addition to the U.S. fiscal line-up for the pennant drive facing us in the late 1980's.

The first part of my paper is a description of the fiscal situation in the late 1980's which calls for the introduction of a broad consumption tax. I also describe briefly the kind of VAT I would like to see and why I think this responds to the situation.

The second part is organized around how to correct a number of specific objections to VAT; that is, I describe a rather idealized VAT. I am not in the game of predicting how much worse a VAT would be enacted. I am giving advice on how to make VAT acceptable. I would oppose a very bad form of VAT but something is lost when advisors don't tell policymakers about a better form, for fear that a bad form will be enacted.

I. THE SITUATION, 1985–90

Why we need a good-glove infielder like VAT is summed up by looking at the 6 heavy hitters that fate is bringing in to bat against us.

A–1. *Over the last half of the 1980's the prospective structural deficit (full employment deficit) under present conditions seems to be about 5% of GNP (an expenditure level of about 24% and a tax level of about 19%).*

This is the Congressional Budget Office estimate.[1] The President's Budget predicts a structural deficit of near 4% of GNP by 1980 but this forecast is very sensitive to the assumption about interest rates. A more realistic rate projection than the optimistic one in the budget moves the deficit up to near 5%.[2] A commentary is provided by the current agony over a $150 billion, 3 year "down payment" on deficit reduction. Allowing for only a little artificial accounting in this total, it works out to reducing the annual deficit by about ½ of 1% of GNP.

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[1] "An Analysis of the President's Budgetary Proposals for Fiscal Year 1985," Congressional Budget Office, February 22, 1984, p. 2.

By our own historic standards this full employment deficit is enormous. From 1955 to 1981 the full employment budget was in balance or surplus in twelve years and the deficit exceeded 1½% of GNP only twice, in 1967 and 1975.[3]

A-2. *Financing this deficit in a no-inflationary way will involve massive crowding out of private investment.*

In 1983 capital imports covered a good deal of the deficits but it is unlikely that this will continue on a large scale once a European recovery gets under way.[4] In 1981 supply siders talked much about private saving providing increased capital but this has not happened.

There are sophisticated arguments which claim to show that the deficit would not result in much crowding out, even if there was no foreign capital inflow. One such argument holds that we should exclude from the deficit so much of the interest cost to government as equals the inflation rate times the public debt (because this should be saved not to increase real savings but to maintain the real value of bond holding).[5] Another is that the public disregards savings held as more government bonds because they also represent a future repayment problem.[6]

The real test of explanations like these is that private savings should have grown as a percent of GNP as the deficit grew. In the last 10 years, however, the gross private saving rate has been in the 16%–17% range, hardly different from the 15%–16% of Dennison's Law and this trifling increase can be more than explained by the increase in capital consumption.[7]

A-3. *Even before crowding out, the level of business investment in the U.S. is too low to be in the national interest.*

This is ultimately opinion but there are a number of carefully reasoned economic viewpoints to this effect.[8] I will, however, ride with the simple political point that every U.S. administration after that of Harry Truman has successfully urged on Congress various measures to increase business investment.

Points A-2 and A-3 together are overkill. Gross private investment in the U.S. runs now about 17% of GNP of which about 12% of GNP is just replacement for depreciation.[9] Even if that were high enough we should worry about crowding out half of net investment.

A-4. *No way will enough income tax loophole closing be enacted to dent the deficit.*

My evidence is Congress itself. If one looks at the performance on the mattter of fringe benefits, it is hard to imagine any serious effort to close loopholes. The currently popular solution, after years of not letting the Treasury close fringe benefit loopholes, is to say that almost anything goes so long as it is non-discriminatory, i.e., so long as there is *more* of it.

A-5. *A significant increase in income tax rates is extremely unlikely.*

Increasingly, legislators are getting advice from economists that the income tax involves very high dead-weight losses. Moreover, with the size of the political investment in a strategy of income tax rate reduction, it is most unlikely that many Presidents and/or legislators will stand on a platform of "I was wrong in '81."

A-6. *Prospects for significantly reducing government expenditures have a success probability near 0.1.*

I offer this as a very personal judgment. The matter of the expenditure outlook will come up again at several points in our case so readers more sanguine than myself about spending cuts should not reject my argument right here.

It is fairly evident that a consumption tax like VAT is at least responsive to these specifications. A broad-based VAT hits nearly half of GNP so a 10% VAT would fill the deficit gap of 4%–5% of GNP, and a consumption-type VAT would bear lightly on Capital formation. To put these numbers in perspective, note that the individual and corporate income tax now produce revenue of about 10% of GNP so a 50% increase in income tax yield would be necessary to cover the 5% of GNP gap. Play those marginal rates on your fiddle!

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[2] Economic Report of the President 1984, pp. 35–6.

[3] R. Eisner and P. Pieper "A New View of the Federal Debt and Budget Deficits" Amer. Econ. Rev. 74:11–29 (Mar '84).

[4] Economic Report p. 53.

[5] Eisner and Pieper, op cit.

[6] R. Barro "Are Government Bonds Net Worth?" Jour. of Pol. Econ. 82:1095–1117 (1974).

[7] B. Friedman "Implications of the Government Deficit for U.S. Capital Formation" in The Economics of Large Government Deficits Federal Reserve Bank of Boston Cont. Ser. No. 27 1983.

[8] Martin Feldstein "Does the United States Save too Little?" Amer. Econ. Rev. 67: 116–21 (Feb. 1977); Martin Baily "The Productivity Growth Slowdown and Capital Accumulation" Amer. Econ. Rev. Proceedings, March, 1981.

[9] B. Friedman op. cit.

In no way am I endorsing a 10% VAT, to be enacted for 1986. In the first place, the deficit problem, as I see it, is long-run, not short-run. A high Federal deficit is as consistent with continued economic recovery as a low one.

It is correct that a high deficit pushes the Federal Reserve into a high interest rate policy, but the Fed policy should, in principle, produce interest rates only high enough to reduce private borrowing by just enough to accomodate the increased Treasury borrowing, under a non-inflationary target growth rate for money. Of course, the Federal Reserve might not get it exactly right, but then they might not have gotten it right if there was no budget deficit. Our economy is subject to occasional recessions and I don't think balanced budgets have much to do with it.

The real reason to reduce the deficit is to reduce the crowding out of private investment. This can very well be done gradually because capital formation is a long-run matter. It would seem to me sensible to introduce a VAT at a 2% rate for 1986 and increase that rate by one point a year until we got the full employment deficit back to zero.

It is most important, for a stabilization standpoint, that changes be enacted gradually. With advance warning, the Federal Reserve can chart a monetary policy to go with a high deficit or a lower deficit. What the Fed can't handle, because of the lags involved in monetary policy, is some precipitous budget balancing action. (The ultimate madness would be some sudden change in the budget in response to that annual display of ignorance, the debt limit bill.)

This gradual program on the VAT rate leaves room for the expenditure cutters and income tax reformers to "put-up or shut-up." If we can reduce expenditures, or increase effective rates of income tax, it may well be that the VAT increases can be aborted at 6% or 8%. There would in fact be some pressure on the appropriation process if there was a recognizable prize waiting for responsible budget action. I think also that the changes for expenditure cuts or tax reform are improved if they can be designed for long-term so transition problems can be minimized.

To review my 6 point diagnosis of the situation that calls for a VAT, point A-1 is solid; there is a large structural deficit in prospect. Points A-2 and A-3 are mutually reinforcing and my case stands if either point holds. Points A-4, 5 and 6 all deal with other ways to cure the deficit. Under my gradual approach to a VAT rate I am completely open to accepting any unexpected strength that might appear in income tax reform or expenditure cutting.

II. THE PROBLEMS WITH VAT

In this paper I intend to refer only generally to the specific provisions of a VAT. On many details I am not greatly concerned which way they go. Other details are important to me and I will describe a version of VAT which could plausibly be adopted.

One not very important detail is whether we call our direct consumption tax a value added tax (VAT) or a retail sales tax (RST). Any uniform direct consumption tax must have a way of deciding which sales are for consumption and which are for business use (i.e., for resale or to be used up in producing something for sale). RST does this by having the seller identify exempt sales, perhaps by certificates from the buyer. VAT withholds tax on all sales and lets the buyer take a credit when the purchase is for business use.

The two techniques could be combined. Under VAT we could avoid taxing and crediting sales of things like steel ingots that never enter consumption directly. Under RST we could require local hardware stores to tax all sales and give professional builders credits for tax paid on business use purchases from local hardware stores.

Conceptually, I prefer the VAT technique because buyers are a better information source on resale than their suppliers, but I am not hung up on technique. I do think VAT has some incidental advantages. Discussion of VAT lends itself to thinking about how to tax nearly all consumption while many RST advocates have not yet caught on that the object is to tax services also. For reasons developed later, I think a Federal VAT has less conflict with state RSTs. It has been suggested that a Federal RST would be preferable if the states would give up their taxes for an add-on to the Federal Tax. That outcome would convert me to RST but it seems unlikely.

Almost everything I say from here on, about curing regressivity etc., fits RST as well as VAT. Supporters of RST are invited to carry their banners in my parade.

By the time VAT or RST legislation passed the Congress it could be so loaded with junk that I would be with those urging a veto. This makes recommending any VAT a tough call. Possibly we sould drop the whole thing because we sophisticates know that the Congress would pass something terrible.

I am not inclined to this level of pessimism because I think we can roughly measure the trade-off terms. The big advantage of VAT is its economic efficiency, its lower excess burden. Of all the problems that I will discuss, the one solid one is the administrative/compliance cost of an additional tax layer. In general the economic efficiency declines and the administrative/compliance costs increase the more we add exceptions, multiple rates and such junk. The point at which any net advantage of VAT becomes negative is, in principle, identifiable.

My idea of a reasonably good VAT is one collected by the credit method with very few exemptions and no multiple rates.

The biggest practical issue of VAT design is the level of exemptions. My preference is to limit exemptions to value added in: Direct and imputed residential rents; medical care and drugs; private education and charitable activities; state and local governmental activity other than business activities like public power; and food produced and consumed on farms.

In general I would handle these categories by way of exemption rather than zero rate, although I think zero rate is desirable for education/charitable activities, states and localities.[10] In a real world tax, more exemptions are likely, an issue that I deal with later.

A VAT with few exemptions can be administered closely with the income tax. The top line of the VAT return would be very close to the business receipts line on the income tax return. The VAT credits are closely related to the income tax deductions, other than wages and interest, plus capital outlays. For both administration and compliance, there would be great overlap between income tax and VAT. In an automated accounting system, there are few data inputs required for VAT that are not already required for income tax, so generating a VAT return is primarily a matter of writing another program.

I would provide an alternate calculation for small business on the evidence that compliance cost runs quite high for small business.[11] The alternate could be a lower rate on gross receipts without credits.

A number of other features of my preferred VAT will be developed in the following discussion of objections, so I don't elaborate here, except to mention that I would not require separate labelling of the VAT, because that detail ties into several of the problem areas.

While there are obvious attractions to a VAT, and specific proposal encounters a number of objections from experienced tax people. The rest of this paper is addressed directly to the most serious of these objections. These are: B-1 VAT is regressive; B-2 An expenditure tax is more elegant than a VAT; B-3 VAT would be inflationary; B-4 VAT introduces a serious conflict with the state use of consumption taxes; B-5 VAT would involve an unacceptable increase in the administrative/compliance cost of our tax system; B-6 VAT, as a hidden tax, will serve to increase government expenditures over time; and B-7 VAT is a political impossibility.

I deal with these objections seriatim while recognizing a good deal of interaction.

B-1 VAT is regressive

In discussing this objection, I assume that we do not want to reduce the over-all level of progressivity in our fiscal system, otherwise it's no objection.

The first point to make is that what we should care about is the aggregate progressivity of the system, expenditures as well as taxes. Progressivity of a tax is usually measured as a percentage of money income. For poor people this can produce a horrendous statistic not because the tax is so high but because money income is so low. More importantly, things that the government does on the expenditure side affect poor people very much more than what it does on the tax side.[12]

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[10] Zero rate does, and exemption does not entitle the favored party to refunds on purchased goods and services. Exemption is complex where one entity does both taxable and zero-rated activities. In 1982 GNP was $3,073 bil. and consumption $1,992 bil. Housing, medical, religious, welfare, private education and research come to about $600 bil. on a zero rate basis and under $500 bil. on an exemption basis.

[11] See R. Henning and J. Kay "The United Kingdom" in *The Value Added Tax, Lessons From Europe*, Henry Aaron ed. Brookings 1981, p. 87.

[12] At least one writer has carried this expenditure effect further, arguing that cost-of-living adjustments, formal and informal, in government welfare programs should be taken into account as cancelling taxes allegedly shifted to the poor in higher prices. (Edgar Browning "The

Continued

Assume the question is to choose between (1) decreasing government expenditures by some amount, proportionately in all categories; or (2) impose a VAT to raise the same amount. The poor would be far better off with the VAT.

This point logically deals with the problem but there is still a political issue of perception. A VAT is perceived as regressive. The argument "You could have financed this poor relief by soaking the rich still more" is equivalent to "What have you done for me lately?" The question becomes one of finding something within the VAT to deal with the perception of regressivity.

The most common anti-regressivity "fix" within a VAT or a sales tax is to except things like food. This has two very severe drawbacks and one advantage.

The first drawback is that it doesn't do a decent job of reducing regressivity. If we had a 5% VAT, a food exemption has the same effect as reducing the rate to 3½% for poor people and to 4½% for rich people. This changes the regressivity very little.[13]

A more important problem is that a food exemption greatly complicates the system, which is ironic because I think the most serious of all these objections to VAT is the compliance-administration cost of adding a new tax instrument.

The big advantage of the food exemption in a VAT is that it gives the legislator something that he can tell his middle-class constituents he did for them. This is valuable but it is also hokum since a 4% tax without a food exemption is practically indistinguishable for most people from a 5% tax with the food exemption.

It seems to me a very simple way to deal with the perceived regressivity problem is to provide what could be labeled the VAT Supplement, an increase in the value of food stamps by about twice the VAT rate.[14] It will still be said that some people who are very poor don't get food stamps. I think this is better treated as a separate problem than as a determinant of national tax policy. My relief proposal, for example, would not help street people who don't use food stamps because they are barely able to function in our society. This tells me that we should find better ways to help street people in general, perhaps by free shelter and meals, than by worrying about the VAT tax they might pay on an occasional beer.

The VAT Supplement could be extended only to poor people, or we could, at the cost of a slightly higher VAT rate, extend it through the whole income scale.

If the process calls for exactly replicating the progressivity of the income tax in the VAT proposal, one needs to combine VAT with fine tuning of income tax rates above, say, the 28% bracket. For a broad 10 percent VAT the top-bracket rate would rise from 50% to about 53%.[15]

B-2 VAT is inelegant

The tax literature has developed in great detail, a highly sophisticated consumption tax called a progressive expenditure tax.[16] In any academic discussion, once you agree on a consumption tax, VAT comes across as a worn-out, journeyman ball player while the expenditure tax is odds-on for "rookie of the year" honors. The pithy answer is that I am not talking about a pennant rate in the academic league, I am talking about the Congressional League where they have barely about this whiz kid "expenditure tax." (VAT has its own problems in the Congressional League; that I will get to.)

I want to address three specific problems in going the expenditure tax approach, and then I offer an olive branch.

Expenditure tax ideas have not had sufficiently wide currency to say that we are close to consensus on converting the income tax to an expenditure tax. There are

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Burden of Taxation" *Jour. of Pol. Econ.* 86:649 (1978). This argument, which has merit, concludes that the tax regressivity problem at low incomes doesn't really exist. My revision differs only slightly, that this tax regressivity is of no importance. In any case the perception of a problem must be handled.

[13] G. Brannon "Is the Regressivity of the VAT an Important Issue?" *Tax Notes,* Dec. 31, 1979.

[14] I guess that ⅔ of the low income budget is spent on VAT taxable items and ⅓ is spent on food. The VAT adjustment rate should be the ratio of the first fraction to the second, whatever the true values are.

[15] It is not settled just what is an iso-progressive increase in income tax. Assume it is one with a uniform ratio to income. The increase in income tax rate in each bracket should bring the marginal rate of VAT up to the ratio of VAT to income at the average income. With a 10% VAT on 65% of consumption (which equals 90% of income) the average VAT rate is 6% of income. In the top bracket we guess consumption falls to about 50% of income (after taxes of 30% and savings of 20%). The marginal VAT falls toward 3.3%. Guessing that at the top bracket the marginal taxable income is about ⅔ of marginal total income, 5 points in taxable income are needed to produce 3.3% on total income.

[16] *What Should Be Taxed: Income on Expenditure?* Jos. Pechman ed. Brookings, 1980.

too many experts who have not been convinced and far too many opinion molders who haven't started to think about the problem.

A second serious problem that I see is that reliance on expenditure taxation would require us to get more serious about death taxation but our lawmakers have been on a kick of gutting the estate and gift tax. This is serious because expenditure tax advocates are asking the general public to change fundamental views about fairness and ability to pay. It is nowadays part of the popular culture that any person with a lot of income has a high ability to pay. To the contrary, the expenditure tax approach says that a "rich" miser is really poor, that he doesn't have much ability to pay. This is a hard sell. I can buy tax relief for rich misers during a lifetime; income not consumed is not much drain on resources. I do think that leaving very rich children is a way of consuming income that has some bothersome social implications.

I am not confident that all expenditure tax advocates are willing to urge a reasonably high tax on intergenerational transfers nor am I convinced that the Congress has much stomach for these things. The collapse on step-up basis is to my mind characteristic of the response to narrow groups of wealthy farmland owners and wealthy proprietors.

My third problem with expenditure tax is the transition problems. It is rough to tell my generation that we had to pay the double tax on our lifetime savings and now, as we retire and dissave, those savings will be taxed again. It will be hard to verify all opening asset accounts.

These three problems are, I think, important but certainly not insoluble, hence, the olive branch. Over the next 20 years we might well move to an expenditure tax. If so, adopting VAT now will provide a quite good beginning of transition to expenditure tax. If we eventually do not adopt the expenditure tax, VAT adds a sensible consumption element to the tax base in a more intelligent way than the present hodgepodge of savings reliefs.

Under the expenditure tax, the analog of wage withholding would be to withhold at the cash register, e.g., by a VAT, with VAT refunds handled by some cash distribution system, e.g., more food stamps. In the ultimate progressive expenditure tax, the first bracket could be permanently collected via VAT with a supplementary return system with high exemptions to collect only the progressive rates.[17]

In the short run my immediate VAT proposal amounts to collecting a broad tax on consumption principles with a refund and collecting the progressive element by way of an income tax. If I am right that we are simply not ready for total reliance on expenditure taxation, this is a very good situation. At any time that we are ready to collect the progressive element by way of an expenditure tax, so be it. By then, it will be an administrative detail whether to continue to collect the first bracket via VAT or collect it via a tax return system.

B-3 VAT is inflationary

There is in the economic literature a very old debate about whether a general consumption tax is passed forward into prices or backward into lower factor incomes. The debate gets into some subtle points about what to assume with respect to the interaction of fiscal and monetary policy. As we did with progressivity, we assume forward shifting since otherwise the problem disappears.

More specifically, the forward shifting scenario assumes a willingness of the Federal Reserve to accommodate the initially higher prices by expanding the money supply above the prior target, so as to prevent these price increases from leading to unemployment. The real problem is that this proces can feed on itself because of widespread formal and informal COLA provisions in our economy. These generate a second round of cost and price increases and to prevent unemployment these too must be accommodated in monetary policy.

A way of dealing with this is to have the Congress enact a law that would require that all contract provisions relating to the official cost of living index would be interpreted in the courts as referring to a new cost of living index which would be constructed by BLS as the present index less the VAT component. Both indexes would be published.

The theory behind this move is that cost of living adjustments are ultimately concerned with the division of real income between contracting parties, normally between capital and labor. Cost of living adjustments are sensible for stabilizing labor and capital shares during, say, an inflation related to general economic recovery. Where the inflation is related to a circumstance outside of the capital/labor nexus such as an increase in a VAT, a cost of living adjustment is pointless; it produces another price increase, and another wage increase etc., like a puppy chasing its tail.

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[17] The Meade Commission in the U.K. which advocated a comprehensive expenditure tax has a Chapter devoted to a "Two Tier Expenditure Tax" in which the basic rate would be collected by way of a VAT with the expenditure tax being collected by return with a high exemption as a way of collecting the higher rates. *The Structure and Reform of Direct Taxation*, Report of a Committee chaired by Professor J. E. Meade, George Allen and Unwin London 1978 pp. 202-215.

This is very much the experience of the 1970's. Most of the inflation of those years was triggered by an oil price increase that was small relative to GNP, and which had nothing to do with the capital/labor nexus. Attempting to compensate labor for oil price increases by higher wages simply caused more price increases and more wage increases.

We should take steps to make the whole COLA process more rational and this could very well be done in connection with a VAT decision. People pay tax whether we collect it as income tax or as excise tax. It just happens that there are a plethora of price escalator provisions out there which pick up excise tax changes but not income tax changes. It has to be silly to let major decisions of Federal tax policy swing on the irrelevancy that one is picked up by COLA provisions and one is not. It is far more sensible to keep the VAT out of the COLA's.

B-4 VAT hurts the States

States are widely perceived to "own" the field of excise taxation, so Federal intrusion is seen as seriously weakening the state's ability to raise revenue from sales taxes. The argument under these perceptions is not very clear.

Both States and Feds live confortably together under the tents of income, tobacco and alcohol taxes. The opportunity to deduct state income and sales taxes against the Federal income tax provides some subsidy for states to use these sources. It costs the voters of a state about 94 cents to raise $1 of sales tax and about $.75 to raise $1 of income tax.[18] One would think this gives the Feds a net credit so a slight burden on States in excise taxation might be tolerated. State people don't seem very tolerant in these matters, so the perception of sales tax conflict must be faced.

There would be a serious conflict at the administrative level if the Feds imposed a retail sales tax. At the cash register the clerk would have to identify items that were taxable under both, under State or Federal only or under neither. This is reason enough to construct a Federal consumption tax as VAT rather than as a retail sales tax. VAT is collected by return as an income tax and does not conflict administratively with the state sales taxes.

If there are no administrative conflicts, there may be psychic ones. Voters in a 5% sales tax state might be more reluctant to endorse a rate hike to 6% if there is already a 10% Federal VAT. In part this is an income effect. If the Feds increased income tax rates by 50%, citizens would have less after tax to spend on the goodies that the states provide. If you dont't like this, you want to argue against the level of Federal expenditures.

There is, however, a matter of price effects as well as income effects. A 50% increase in Federal income tax rates, with unchanged deductibility for State taxes would decrease the marginal cost of raising State taxes, in a way that does not seem to occur under VAT. I don't think this price effect is important for two reasons.

In the first place, some marginal price effect of encouraging state taxing and spending arises under VAT with state activity zero-rated. This price effect arises under both an income tax and a consumption tax when there is no tax to the extent that citizens choose to consume some income collectively through their state governments. Under an income tax, and an expenditure tax that were equally progressive, the two price effects would be equal. When we have a combination of income tax and VAT that were structured to be as progressive as the income tax alone, the price effect toward state spending would have to be the same. The point is a subtle one. Imagine that we had separate taxes, one that collected the first bracket of the income tax and another that collected the progressive rates. Arguing that a stronger price effect toward state spending arises from the progressive rates would be irrelevant if we knew both taxes would be collected. Similarly it is irrelevant if some of the first bracket rate is collected via VAT with State activities zero rated. Actually, introduction of VAT in an iso-progressive change of the income tax should slightly strengthen this price effect because on many inome tax returns the zero bracket rule negates the effect of State tax deductibility.[19]

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[18] In 1979 states and localities raised $37 bil. in individual income taxes of which $29 were reported as itemized deductions. Guessing at the marginal rates under current schedules, this saved $9 bil. in Federal taxes. The general sales tax figures were $47 bil. raised, $18 bil. itemized for a tax savings of $3 bil.

Finally, I offer the comment that the small amount of evidence we have is that the price effect is less important than the income effect. After the 1930s and prior to 1964, there were few State income tax adoptions or increases. In this period the Federal income tax rates were high at the margin so the price effect should have been strong. After 1964, the income tax rates fell, lowering the price effect but raising the income effect. State income tax increases proliferated.

B-5 Administrative and efficiency cost of VAT

My diagnosis of the situation, in the first part, included assertions that income tax would not be increased. These assertions were partly a political judgment and partly based on a judgment about the advice legislators get from economists. In this section we ask what economists should be telling policymakers.

VAT involves an additional administrative/compliance cost (a/c cost) of a new tax alongside income tax. But, a broad based VAT should produce less inefficiency (less excess burden) than would an increase in income tax rates (the e-gain). No precise conclusion about whether a/c cost exceeds e-gain is possible, because one doesn't know how complex and selective would be a VAT finally adopted by the Congress, nor does one know whether the income tax yield might be increased by loophole closing, i.e., by reducing some present excess burden. Moreover, measurement of both a/c cost and e-gain is at an early stage.

A detailed study has been made of a/c costs of VAT in the UK including both the administrative costs of the collector and the compliance cost to taxpayers. As pathbreaking studies go this recognized various ways of handling particular problems, so it concluded that the total a/c cost of VAT in the UK in 1977/8 was between 12% and 9% of VAT revenues.[20] At that time the standard VAT rate was 8% with a higher rate of 12.5% on some goods; food and a few other things were zero rated; various consumption goods were exempt. The U.K. tax was complex as VAT's go. In 1978 the standard and higher rates were consolidated at 15% and some simplifications in procedure were adopted. Probably the a/c costs were reduced to the 7%–5% level.[21]

Translating these numbers to the U.S. is complicated. If the U.S. tax were like the British tax, with food zero rated etc., we would need a standard rate near 15%, so the 7%–5% estimate is appropriate. If we eliminated some of the British zero ratings and exemptions, especially the food rule, we would have a 10% rate with about the same revenue yield as the British tax and an a/c cost near 5%.

As tax costs go, this is remarkably low. One estimate of the a/c cost of the U.S. individual income tax system would put it generally around 10% of the revenue.[22] Higher income tax rates would likely increase the dollar amount of a/c cost, although not proportionately. A significant rate measure would increase pressure for special raliefs. Revenue increase by way of loophole closing could, but certainly won't, decrease this cost. One need only read TEFRA.

Calculating the e-gain from VAT is a matter of calculating the excess burden associated with those non-neutralities in the income tax that would be eliminated by VAT, but this is conditional on specifically what exemptions would be in the VAT. One estimate by Gravelle puts the excess burden of the income tax treatment of savings at about 10% of the revenue.[23] Almost certainly VAT would continue to exempt the return on owner-occupied housing so that e-gain on the savings/consumption score would be less. On the other hand, a massive income tax rate increase would greatly increase the excess burden. Some e-gain also arises from reducing income tax discrimination between types of income and uses of income, but how much VAT would differ is unclear.

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[19] The point doesn't hold if states are only exempted from VAT but not zero rated. In this case, however, the decision to reduce the tax encouragement to state activity would have been deliberate and is not a basic disadvantage of VAT.

[20] C.T. Sandford, et al., *Costs and Benefits of VAT* Heineman Educational Books London pp. 104–7.

[21] Ibid p. 145.

[22] Joel Slemrod and Nikki Sorum "The Compliance Cost of the U.S. Individual Income Tax System" Research paper for the U.S. Treasury Dept. unpublished.

[23] Jane Gravelle "Capital Income Taxation and Efficiency in the Allocation of Investment" *National Tax Journal* 36: 297–306, Sept. 1984.

B-6 VAT will increase Government spending

Before turning to specifics on this objection to VAT, I want to explore the theoretical connections between the tax policy decisions and government expenditure decisions. Which comes first?

President Reagan, and many conservative writers, have adopted a taxes-first position. The 1981 tax cut, in the face of sharply growing defense expenditures, was seen as a discipline to force the Congress into accepting reduction in non-defense expenditures. To go back on the tax cut is seen as removing this pressure on the Congress.

If a deficit led to some obviously unpopular outcome, like runaway inflation or recession, this tactic might be plausible. My argument in the first part of this paper was that the mischief of the deficit is crowding-out; the penalty falls on the basically conservative target of private investment. The various spending lobbies for the aged, the hungry, the environment, etc., certainly have little concern to sacrifice their spending goals for more private investment. A "cut-taxes first" position should lead to permanent deficits before it leads to economy in government expenditures. This is what happened.

Let me articulate the opposite view of deciding expenditures first by explaining some personal views on defense expenditures. Over the past two years the Congress based decisions on defense spending on the Troika theory, which holds that despite having a safe and credible delivery system of nuclear deterrents based on submarines, it is important that we match, at all times, the Soviet delivery system based on land missiles and bombers. This led to large spending commitments to MX, B1, etc.

For argument give me two assumptions: (1) I as a voter do not find the Troika theory very sensible; and (2) the Congress does accept the Troika theory. What should I do? It is sensible for me to support legislators and public groups that urge lower defense expenditures. I insist that it is not sensible for me to sulk and say that I am so mad about having lost my position on defense that now I will oppose paying for the defense program that our democratic system has voted.

I think that non-defense spending is not very different. The President apparently feels about some domestic programs as I felt about the Troika theory. He regrets the decisions made since 1981 on food stamps, agricultural price supports, urban mass transit, etc. On quite a few of these non-defense programs my feelings are with the President.

I hear the President saying quite explicitly that he will veto tax increases that don't have expenditure cuts and cuts specifically in programs that he doesn't like. If he can't have his way on expenditures, he wants a high deficit to punish the miscreants. My argument is that this punishes the wrong people.

To the extent that tax considerations should impact on the expenditure policy it seems rational to me that this should be prospective, as it would be in my proposal for gradually increasing the VAT rate. Over the next several years a new generation of decisions on weapons should be made in the light of "these things will cost money." Winston Churchill said it well, that defending Britain was a matter of "blood, sweat and tears." Unfortunately Americans were told that they could stand tall for free.

B-7 Is VAT politically possible?

Political forecasting is so highly uncertain that tax specialists should tell the Congress what they think on policy and not worry about political possibilities. Most of us like the political game, however, so we won't pass up the chance to discuss it.

To start with, adoption of VAT requires that it be proposed by a President with a good deal of spade work by the Treasury and with a large public-relations efforts running alongside. No Presidential candidate has promised such an effort but being elected commonly changes candidates.

Assuming Presidential support, the chances of selling VAT are not hopeless. The periodic ACIR surveys show a great deal of public sympathy for the retail sales tax and much hostility to the income tax. Apparently there is much support for spending programs and much hostility to massive budget deficits in the long run.

A serious consideration is that unlike an income tax proposal VAT does not challenge established lobbies with all their PACs. There are strong organizations prepared to do battle on each effort to broaden the income tax and most of these organizations have a winning streak going. In the context of a VAT starting at a low rate, the presence or absence of a particular preferential treatment simply doesn't mean much and the special interests will not have the advantage of working from positions that they have been fortifying for years.

CONCLUSION

In the Federal budget outlook for the 1980's no strategy looks really good. One of the possibilities, a broad based consumption tax, has had particularly bad press as being regressive, inflationary and a lot of other bad things.

My conclusion is that most of these bad things can be fixed, which would advance the vedict on VAT to "Not bad." Considering the alternatives, this verdict is good.

Chairman ROSTENKOWSKI. Mr. Conable will inquire.

Mr. CONABLE. There are lots of problems about energy taxes. Certainly, energy taxes evoke an unseemly regionalism in this country. In this Congress, you always have a problem. If you have an oil import fee, what does it do to New England and what kind of retaliation against a credit for New England might be insisted upon by Florida and California in return? Before you know it, we are in bad trouble, significantly reducing the revenue that could come from such a thing.

I recall Russell Long, who should never be ignored in this Congress, talking about some kind of an energy tax that would be imposed somewhere between the wellhead or the mine entrance and the consumer on a much broader basis than just the taxation of oil or the imposition of an import fee.

Is there any way to handle an energy tax that does not instinctively, inevitably evoke this regional result? I have never been sure what Russell was talking about, but as I say, you ignore him at your peril here.

Mr. BRANNON. The general tax you talked about would be a little less regional than a tax on the specific energy source, simply because some sources are more closely associated with a particular region, but there would be some regional differences just in energy usage between regions.

So there is, I think, a slight remaining regional problem, probably not very severe, if that is all you are talking about.

Mr. CONABLE. How would you impose such tax, though? What would be the incidence of such a tax?

Mr. BRANNON. It would have an incidence much like a general sales tax. It would relate to, pretty much to general consumption. The imposition would be fairly complicated, since you would have to work out the sort of BTU equivalent of various energy sources and decide at which particular point each source would be taxed.

Hydroelectric plants, gas distribution centers and all of that, it would be a very complicated tax, and one that basically involves a lot of distinctions which don't seem to be worth all this trouble.

If you want to tax consumption, tax consumption of labor services as well as consumption of energy services.

Mr. CONABLE. Your suggestion is that any windfall profits tax not be imposed on a kind of temporal basis, but on a percentage production basis, and it would seem to me that therefore, you would have to exclude all new energy sources, Mr. Brannon.

Mr. BRANNON. That is what you largely try to do. It is uniquely the existing wells that are more or less in production that you worry about.

That is what you were worried about when you imposed import quotas, when the price went down, and that is what you worry about when the price goes up and these existing wells seem to get a much bigger return then they expected to get when they were drilled.

Mr. CONABLE. In the last windfall profits tax, we were not totally successful in keeping the tax off all new wells, at least initially, were we?

Mr. BRANNON. The big problem there is the definition of new wells. You get different production wells in one property, it is a difficult matter, and secondary recovery is an important part of production.

Mr. CONABLE. Thank you, that is all I have, Mr. Chairman.

Thank you, Mr. Brannon.

Chairman ROSTENKOWSKI. Thank you very much, Mr. Brannon. It is always a pleasure to have you with us.

The committee stands adjourned until 2 p.m.

[Whereupon, at 11:45 a.m., the committee recessed, to reconvene at 2 p.m.]

AFTERNOON SESSION

Mr. PICKLE [presiding]. The committee will come to order and we will proceed now with a panel which consists of Mr. Frank Zarb, who is general partner of the Lazard, Freres Co. and was the former Administrator of the Federal Energy Administration and former Assistant Secretary of Labor, perhaps the first energy "czar" we have had in this country. We are pleased to have you here, Mr. Zarb.

STATEMENT OF FRANK G. ZARB, GENERAL PARTNER, LAZARD, FRERES & CO. (FORMER ADMINISTRATOR OF THE FEDERAL ENERGY ADMINISTRATION; FORMER ASSISTANT SECRETARY OF LABOR; AND FORMER ASSOCIATE DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET)

Mr. ZARB. Thank you, Mr. Chairman.

In light of saving time and serving the function of answering any questions you may have, I will submit my statement for the record and briefly overview it.

Mr. Chairman, it is fairly clear to me in the last 10 years of struggling with the question of energy and energy policy that when you adjust tax policy regarding energy, you really are adjusting energy policy, and with that in mind, I don't think you can do one, that is deal with the tax issue without recognizing that this Nation still has an energy past and an energy future. We have learned in the last 10 years that we continue to have something of a vulnerability to interruptions albeit the extent of that has changed.

We understand better the nature of OPEC, its capabilities and what it is not capable of achieving. We have learned that Government intervention in pricing has been a destructive element in energy policy over the years and the Nation as a whole has created a bipartisan program to undo that intervention. I think we have learned that Government policy can be geared to support reasonable measures which would stimulate production of domestic energy as compared to that which is imported.

We learned that oil and gas cannot carry the burden alone and that coal and nuclear power are essential elements of our total profile. We learned that we can handle an energy crisis. As you will recall, particularly you Mr. Conable, during the 1973 to 1974 embargo, we enjoyed good bipartisan support to create emergency measures to deal with the issues as they occurred, and as much as we complain about it, the fact is we had a lot of support in the Congress and in the Nation as a whole.

We can say that because of our response as an entire Nation in the last ten years our energy profile has improved. I won't go through the statistics, but we are using less energy per unit of output, we are using less energy that comes from more vulnerable spots in the world. We have improved our total mix of both energy consumption by product and by points of geography. The economics of energy have generally gotten better not only from the standpoint of industry, but of individuals and on page 5 we have a chart showing what has happened to motor gasoline as compared to supply, demand and real income.

We can't ignore the fact that we have been embargoed several times and we will probably be again, although the impacts of these embargoes will change as time goes on.

I would like to move along to the areas of unfinished business in energy policy.

On page 8, I outline a few areas that I think still need attention if we are going to have a complete energy policy. The deregulation of natural gas is a subject dear to my heart and I still have a good many scars related to that subject. It is too bad that this Congress didn't do more to unravel controls during this session. It was a good opportunity to do it while prices were down and I have to say that both the administration and the Congress were disappointing in that regard.

So we need still to deal with that issue. We need to make some sense out of nuclear power policy. The regulations pertaining to it both nationally and locally are inconsistent with the best interests of this country. I know between now and November that is not a subject that anyone here will want to discuss, but I would hope that in the next session that is an element of the energy future that is taken up. Progress has been made with regulatory stability and balance in the mining and burning of coal, but we are not completely there yet, although a great deal of improvement has been made. There is always the threat of moving backward and I hope we can remove those threats.

The offshore debate continues and we seem to hear more and more voices that call for blocking areas in the Continental Shelf. That would be a terrible mistake. Regulatory and economic policies which would assure regulated energy industries, such as public utilities, equal access to capital markets, is, I think, a key area. In my view, the utilities of this country by and large are in trouble and while you won't see the effects of what we are percolating now—in the next year or two—this Nation will suffer because of things not being done now, but these effects will not be felt until the late 1980's.

Let me go on to energy consumption taxes and comment on what might be the impacts of energy consumption taxes on our energy capability as a country. The three taxes normally discussed are the oil import fee, an excise tax on gasoline and/or other petroleum products, and a tax on the "Btu value" of energy or energy value of oil or most energy products. We have had some history there. You will recall when President Ford proposed a $2 a barrel tax on oil consumption and a companion tax on consumption of natural gas or Btu equivalent, we imposed unilaterally by Presidential order a tariff on imported oil that was first $1 and then $2. That was part of a confrontational policy that we were involved with in those days trying to get off center in a dispute between the Congress and the administration.

The administration prevailed in that challenge. We then made an agreement with the Congress and removed that tariff when an energy bill was subsequently passed that the President could accept. But the initial effort of President Ford to raise prices by way of a tax was never seriously debated in the Congress and was not passed. In 1975, the House Ways and Means Committee reported a 23-cent gasoline tax. I remember talking to Chairman Ullman about the energy impact of that tax. We (the administration) didn't support that tax because in my view a gasoline tax I felt was bad energy policy and I still do. It was bad policy, it was bad politics and never got anywhere.

President Carter also proposed a $5 a barrel import fee and that, too, was defeated by the House. President Reagan proposed and Congress adopted a 5-cent a gallon increase in the Federal tax on gasoline and other motor fuels and his efforts didn't get anywhere. I think it is fair to conclude that it is a lot easier for us to technically construct a tax on oil and oil products—with all its complications, it is easier to do that than to get one enacted.

On page 11, I outline the revenue effects of various taxes that the CBO has presented. You are familiar with those so I won't go into those in detail.

Let's talk about some of these consumption taxes a little more specifically. With regard to energy policy issues raised by the energy consumption taxes if you seek to reduce U.S. expense on oil imports an oil import fee itself is probably m ore effective than a gasoline tax or broad-based "Btu" tax because an import fee makes oil imports more expensive to consumers relative to domestic energy sources.

At the same time, the import fee would reward domestic energy production and conservation more relative to production of other goods and services in the economy not so protected by an import fee. Our experience with an import fee alone was horrendous, and if we do anything I hope the one thing we don't do is move toward an oil import fee. That, in itself, is, in my view, disruptive.

An oil import fee rewards other imported fuels at the expense of imported oil. There is a sizable amount of natural gas and falling water in Canada, and U.S. dependence on Canadian gas and electricity imports has substantially increased in recent years, even as real imported oil prices have declined. In addition, Algeria as well as Arab OPEC producers have expressed interest in reviving liquefied natural gas imports to this country.

For this reason, it is unclear, at least to me, whether a sizable tariff on imported oil would enhance our energy security or simply replace our oil imports with imports of other energy commodities such as natural gas and electricity. It would indeed be ironic if a fee on our oil imports, three of the top four suppliers of which are Canada, Mexico, and Venezuela, would only result in increased imports of other fuels from those same countries.

So I would say that an import fee, of all the measures before this committee, would get a zero on a zero to 10 rating index.

If our energy goal as a nation is to reduce energy consumption generally, a broad-based Btu or value-added energy tax probably would be more effective than either an oil import fee or a gasoline tax. A gasoline tax, obviously, would have a disproportionate impact on transportation energy consumption, and has been proven time and time again not to be a plus for energy policy, and I don't think a good measure for the economy as a whole.

Our goal of reducing energy consumption for its own sake, separate and apart from reducing dependence on imported oil, has never been the goal of U.S. energy policy. Some economists are continuing to argue that we should tax oil, gas, and coal to reflect the inefficiencies of world markets in pricing the long-run replacement value of depletable resources. However, I have yet to find an economist who can supply me the prerequisite to such a tax: an accurate estimate of all the recoverable oil, gas, and coal left in the Earth's crust. Absent such an estimate, a fossil fuel replacement value tax is difficult, if not impractical, to calculate.

Of course, to the extent any energy consumption tax reduces demand, it will also reduce domestic energy production, both in the short term and the long term. Although we do not know how much oil and gas is still to be discovered in the ground, we do know enough about the geology of oil and gas wells and coal mines and about the engineering of powerplants and oil and gas pipelines to know that it takes a lot of money before we get our first barrel of oil, cubic foot of gas, ton of coal, or kilowatt of electricity into the hands of our customers.

In the case of oil, gas, and coal, we also know they are getting even more expensive every day relative to investments in other goods and services. That is surely true as we push back the frontiers of exploration deeper into the Earth and closer to environmentally sensitive areas.

If there is one thing we all learned in the first days following the 1973 oil embargo, it was this: you can quietly discuss national energy policy with all the experts behind closed doors without once hearing the question, "Is it fair?" But talk to one irate motorist stuck in a gasoline line without answering that question, and you have guaranteed yourself a lynch mob of thousands.

The equity issues raised by various energy consumption taxes are well-known to this committee. As a general matter, excise taxes, of which energy consumption taxes may be one form, are regressive. This is especially true with regard to energy consumption patterns in this country, where low-income families apparently spend a higher percentage of their disposable income on energy than middle and upper income families.

Energy taxes also disproportionately impact different regions of the country and different sectors of the economy. The Northeast is more dependent on heating oil and imported petroleum products than the rest of the country; an oil tax and especially an oil import fee would disproportionately impact that region. A gasoline tax would certainly affect the transportation sector more than other sectors of the economy, and would disproportionately affect transportation-related jobs such as in trucking, tourism, and the airlines industries.

A broad-based energy Btu tax would be more equitable in its effect on energy users as a class, but would disproportionately affect energy-intensive sectors of the economy, such as manufacturing—steel, auto, chemicals. And adjustments would have to be made to those companies who compete in the export market.

In addition, a broad-based Btu tax will always raise practical questions concerning what energy sources to include or exclude—Wood? Solar? Geothermal? And how to calculate the Btu value. We know from past debates over energy and tax legislation, such as gasoline rationing plans, the Fuel Use Act, or any tax bill we could name, the more ingeniously inclusive a regulation or tax, the more ingenious the efforts by those being regulated or taxed to legislate an exclusion for themselves in the law.

You will recall the exclusions we had in the original allocation law, and it got to the point where almost everybody was entitled to an extra supply of gasoline during the embargo period, so it lost its effectiveness.

A final equity consideration relates to the indirect impact of energy consumption taxes on energy producers. Over the last 10 years, led by the members of this committee as well as the Senate Finance Committee, Congress, and administrations of both parties have undertaken a vigorous review of the impact of our tax system on incentives for work, savings, productivity, innovation, and the formation of capital.

One of the fundamental questions this committee must address in reviewing energy consumption taxes is whether an otherwise fair and equitable tax on the consumption of energy commodities or goods is rendered unfair because it singles out energy commodities for taxation.

Let me just sum up this portion of my statement by saying that because of the substantial improvements in our national energy situation since the last disruption, any energy consumption tax is far more likely to be judged by the American people as to its fairness and social equity than as to its beneficial domestic energy impacts. When they are not sitting in lines at the pump, American motorists care more about the price of gasoline than its country of origin.

Taxes on energy production, Mr. Chairman, has been debated ever since I remember looking at the issue of national energy and oil policy. We seem to never let this issue go, and each year it comes up for review.

I won't get into this in great detail except to say that it would seem to me that a period of consistency is in order with respect to this provision of the code. At this moment in time, the Tax Code tends to encourage oil and gas production no more, in my opinion, than it encourages investments in other enterprises, especially when the effects of the windfall profits tax are considered.

There is a debate regarding exploration risk and the special provisions for that risk. And, without going into detail, I advise the Congress not to dabble back into those particular benefits at this moment. The energy situation continues to change, and it seems to me that we want to pull up the national energy tax tree every few years to see if it has roots, and then we plant it somewhere else. Just the process of doing that has had a negative effect on the ability of the energy industry of this country to plan for the future.

I would end up here reading my last summary.

I know the task of this committee will not be easy, but I do have confidence. This Congress is going to look around and say, "Where do we get the money from?" And someone is going to say, "There is energy and there is good, old oil," because oil has been up and now is down, we can take some rent off the top and it can have some beneficial effects over the long term.

There are as many negatives as positives in that conclusion. And I would hope that the Congress will keep all the negatives in mind as it moves forward.

My old friend, Herb Stein, recently said:

> There seems to be an anti-immune system in the political economy that causes it to reject elements that are incompatible with its effective functioning . . . What makes the economy function well is that a hundred million people get up every morning and go to work doing the best for themselves that they can. As long as that happens, the economy will be strong enough to resist policy errors within a considerable range, and provide time for correction.
>
> The key is to preserve the freedom of those hundred million people to get up every morning and do their own thing.

As we consider special taxes on oil and oil products, it may be well to remember that a great many of those 100 million Americans go to work every morning in their cars.

May I answer your questions, sir?

[The prepared statement follows:]

STATEMENT OF FRANK G. ZARB, GENERAL PARTNER, LAZARD, FRERES & CO. NEW YORK, NY

Mr. Chairman and members of the committee, I am pleased to have the opportunity to discuss energy taxes and national energy policy with you today.

Because the Committee has asked me to speak primarily on the issue of energy taxes, I will not discuss the merits of increasing taxes versus cutting Federal spending or expanding economic growth in order to reduce the Federal budget deficit. Nor will I discuss the merits of energy taxes versus taxes on other commodities, goods or services. Finally, I do not intend to plow over the ground already covered by the distinguished Chairman of your Oversight Subcommittee, Mr. Rangel, in the extensive hearings he held on this subject on May 5 and 6, 1983. The views I express are solely my own.

I will review various energy tax proposals and how they could impact our national energy situation. Because of the current low visibility of energy policy issues in the public's mind, it is particularly important that any energy tax proposal take into account its pluses and minuses for our national energy policy. It goes without saying that when you adjust tax policy in regard to energy, you adjust energy policy.

Energy Taxes in context: 10 years of progress in United States and world energy change

Before discussing energy taxes, it is important to understand the progress we have made in the last ten years since the 1973–1974 oil embargo and the 1979 Iranian revolution. It is also useful to understand our current energy situation and the outlook for our energy future.

Without going over a blow-by-blow review of energy events since 1973, but just looking back over the last 10 years, one can detect a sense of direction, some accomplishment, and some lessons learned. For example:

1. We learned that the Mideast supply line is fragile, and we should be prepared for more interruptions which are likely to come. The Strategic Petroleum Reserve appears to be right for national security and a good investment for the taxpayers. At 430 million barrels, the Reserve is now of sufficient size to be useful in deterring

political disruptions in world oil supplies and in calming world oil markets during such disruptions.

2. It was well demonstrated that OPEC is not able to use oil to achieve political goals, but that as a price-fixing cartel, it is relatively durable. At the same time, American consumers and consumers in other industrialized democracies, consuming and producing in their own market-based economies, deserve the lion's share of the credit for the recent reductions in world oil prices, and they expect to receive the lion's share of the economic benefits from such price reductions.

3. We learned that government intervention in energy prices produces only negative results. Deregulation of world oil markets has been good for U.S. and Western oil-consuming nations, and has stimulated increased domestic energy production and energy efficiency.

4. We learned that government policy should be geared to support reasonable measures which will stimulate the production of U.S. energy.

5. We learned that crude oil and natural gas cannot carry the burden alone, and that the nation needs a major contribution from coal and nuclear power.

6. Finally, we learned that we as a nation can rise to emergency situations such as the 1973 embargo. While at the time of the embargo I complained about incompetence in Congress as well as the private sector, there were many more examples of bipartisan statesmanship and more than a few extraordinary deeds by private companies which went beyond the normal call of duty.

Our current energy situation can be summed up in four words: confident but not complacent.

This nation's energy situation is substantially better than it was 10 years ago. Today, the United States is better prepared to respond to an energy emergency than it has been at any time in recent history.

Net imports of crude oil and petroleum products (including imports for the Strategic Petroleum Reserve) averaged 4.3 million barrels a day in 1983, more than 50% lower than the high of 8.8 million barrels a day in 1977. For the 4 weeks ending August 1984, net imports averaged 4.0 million barrels a day, 27% below the average a year ago.

More important than the level of imports, however, is the international energy supply picture, which has improved since 1979 when the United States experienced its last supply shortage. Lower world-wide oil demand, coupled with increases in crude oil production capacity, have led to a very substantial, current oil surplus. This, in turn, has led to decreases in world oil prices. In March 1983, OPEC reduced its marker crude oil price by 15% from $34 to $29 per barrel, a price that is not likely to be pushed up by OPEC in the near future, barring a major supply disruption.

At the same time, non-OPEC oil production has increased and thus diversified the sources of our oil supply. In 1983, Arab OPEC countries provided only about 12% of our net oil imports, and no Arab OPEC country was among the top four suppliers. Mexico was our single largest petroleum supplier. Canada ranked second, and Venezuela and the United Kingdom were third and fourth. Saudi Arabia, once our top crude oil supplier, was in fifth place, only 2,000 barrels per day ahead of Indonesia.

During 1983, the U.S. imported 28% of its consumption of crude oil and petroleum products, compared to 46% in 1977, the watershed for imports. 1983 saw the lowest level of imports since 1972, the last full year of petroleum import controls.

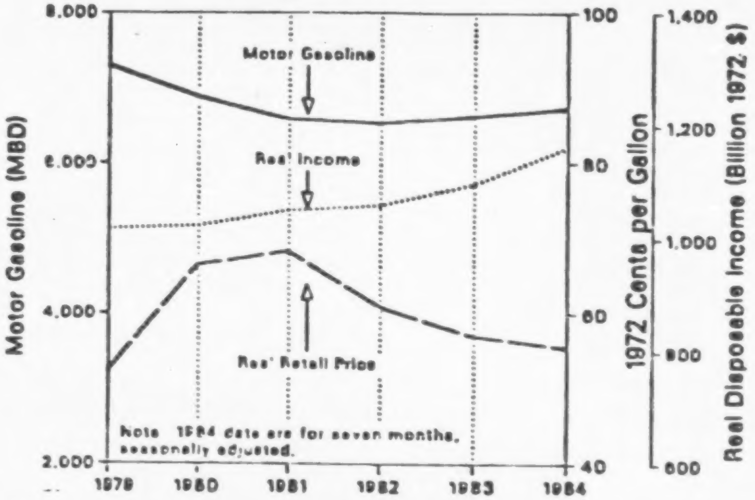
We have not only diversified our sources of oil supply since 1977, we have diversified our entire energy base. In 1977, imported oil constituted 22% of U.S. energy consumption. In 1983, oil imports provided only 12% of our total domestic energy needs—45% less than 1977. Between 1972 and 1983, energy production from non-oil and gas sources—specifically coals, nuclear power, and hydropower—increased from 28% of total U.S. energy production to 39.4%.

One of the most notable changes in our energy picture—indeed, in our entire economy—has been the persistence of improvements in energy efficiency, even during periods of sustained economic recovery. The role energy conservation continues to play in the economy is indicated by the fact that energy consumption per dollar of GNP actually declined in 1983, the first year of the economic recovery. In fact, total U.S. energy consumption declined 0.5% in 1983 despite a 3.4% increase in GNP and a 13% decline in crude oil prices. Energy productivity per dollar of GNP continues to outstrip GNP growth in 1984, with total petroleum products supplied for the first 240 days of 1984 running only 4.9% ahead of the same period in 1983—well below the Commerce Department's estimate of GNP growth for the first two quarters of the year.

Finally, you ask what has this all meant to you and me and American families? The following chart graphically illustrates the direct consumer benefits of our improved energy picture:

MOTOR GASOLINE SUPPLIED, REAL GASOLINE PRICES, AND REAL DISPOSABLE PERSONAL INCOME

EXHIBIT I



Sources Department of Energy, American Petroleum Institute, Oil and Gas Journal, Department of Commerce

This chart shows real gasoline prices, real disposable personal income, and motor gasoline supplied for the period 1979–1984. It shows what we have all seen at the gas pump since 1981: real gasoline prices have fallen over 15% between 1981 and 1983 and have remained flat or declined still further during 1983–1984, even as the economy has recovered, demand has turned up, and disposable income has increased.

Despite all these facts and figures, Americans, twice burnt since 1973 by OPEC pricing and supply policies, insist that in energy policy "the proof is in the pudding"—in short, how well can our nation and our economy as well as other free nations and the world economy weather physical disruptions in world oil markets?

Fortunately, twice since 1979 the U.S. and O.E.C.D. countries have had front row seats to observe the ability of the world oil market to absorb physical, political disruptions in oil tanker traffic in the Persian Gulf.

First, in the fall of 1980, at the outbreak of the Iran-Iraq War, Iran attacked Iraqi oil export facilities and the resulting war knocked out slightly more than 3 million barrels a day of oil exports from the region. This disruption did not cause the same severe price shocks that accompanied the 1973 embargo and the 1979 Iranian revolution. Most energy experts attribute stable world oil prices during this disruption to increased energy conservation due to the 1979 price increase and the availability of high world oil stock levels.

Second, only last spring we witnessed daily oil tanker attacks and sinkings in the area of Kharg Island in the upper Persian Gulf during an escalation in the Iran-Iraq War. As those of us in government and the financial markets collectively held our breaths, a funny thing happened in world oil markets: spot crude and product prices remained stable and even declined between January and August 1984. 98 octane gasoline on the Rotterdam spot market actually dropped from $32.24 a barrel on January 27, 1984, to $29.31 on August 3, 1984. Heating oil on the New York spot market declined from $44.10 to $31.71 over the same period. Of course, some of these variations were seasonal, but financial publications widely reported stable and soft world oil prices inside and outside OPEC throughout last spring and early summer, even as Iran and Iraq traded air-to-ground missile attacks and even as the usual surge in summer gasoline prices should have been occurring.

Although it is still unclear exactly why world oil tracked the price paths it did last spring, it is clear that the complementary, bipartisan U.S. domestic energy policy of deregulating oil markets on the one hand while rapidly filling the taxpayer-financed Strategic Petroleum Reserve on the other hand, was a key factor in the stability and resiliency of world oil markets during last spring's violence in the Persian Gulf.

The U.S. Strategic Petroleum Reserve (SPRO) now contains over 430 million barrerls of oil—over 90 days equivalent supply of current U.S. oil imports and over 1,000 days equivalent supply of our Persian Gulf imports. Because of its deterrence value, the U.S. SPRO constitutes one of the most massive and activist interventions by any Western government in the day-to-day economics of world oil markets. The mere existence of such a hugh government stockpile has served to calm world oil markets in the face of mideast uncertainties.

Although U.S. and Western economies can be confident in their current energy situation, we cannot afford to be complacent. Although the U.S. has reduced its own oil imports, we cannot ignore the fact that the economies of the U.S., Western Europe, Japan, Israel, and non-exporting Third World Countries in Africa, Asia, and South America are all in this together, and a supply disruption affecting one will affect all—especially if our diplomatic oil-sharing obligations under the International Energy Agreement are triggered.

In addition, any country such as the U.S. which continues importing over 30% of its oil needs from abroad while watching its own oil and gas exploration activities decline nearly 40% since 1981, cannot afford to be complacement about its energy future. The number of active drilling rigs fell from a peak of 4,530 in 1981 to 1,846 in April 1983, before turning up this year to 2,435 as of the week ending September 17, 1984—still far below the 1981 peak. As drilling for and finding domestic and non-OPEC oil and gas supplies become more and more expensive and more and more risky, the U.S. must carefully review its energy policies in order to foster the diverse and secure energy resource base it will need 10 and 20 years from now. In short, the energy agenda is unfinished.

Among the unfinished items are:

Deregulation of all natural gas by a date certain.—Although the expiration of certain natural gas price controls in 1985 under the Natural Gas Policy Act of 1978 will help, it makes no sense to continue controls indefinitely on 40% of domestic gas supplies, especially when those supplies are likely to be less expensive to produce than new supplies. On the other hand "freezing" or "re-regulating" natural gas prices would be disastrous for U.S. domestic energy policy and would only set the stage for domestic shortages and higher prices in the future. It is too bad the Congress and the Administration did not work harder on an expedited deregulation bill during this Session.

Rational and simplified licensing of nuclear power plants.—A way that reduces the time it takes to license a new plant while at the same time assuring public health and safety, and, above all, public confidence. It makes no sense that the U.S. abandon its domestic nuclear power option at the same time other industrialized countries such as France, Germany, and Japan are aggressively promoting their own. When half the cost of building a plant is the interest cost of money during construction, it is no wonder that licensing delays have effectively rendered new nuclear power plants uneconomic. Leadership from Congress and the utility industry and electricity consumers is desperately needed if the nuclear option is to survive.

Regulatory stability and balance in the mining and burning of coal.—The future of coal as the boiler fuel of choice, especially in the Midwest, in hamstrung by the regulatory uncertainties surrounding the Clean Air Act and acid rain.

Access to Federal on-shore and off-shore lands for energy exploration.—One of the worst national energy policies the U.S. could adopt during the current stability in world oil markets is to over-mortgage our energy future by placing millions of acres of Federal lands off-limits from energy exploration, or in indefinite statutory limbo.

Regulatory and economic policies which assure regulated energy industries, such as public utilities, equal access to capital markets.—The financing necessary to improve productivity, replace obsolete plant and equipment, and innovate and develop high-risk alternative energy resources such as solar, wind, geothermal, and others.

Energy consumption taxes

With this overview on national energy policy in mind, I would like to comment on the issues raised by specific energy tax proposals. It is useful in reviewing these proposals to discuss taxes on energy consumption separately from taxes on energy production, because each raises different issues of efficiency, equity, and national energy policy.

Energy consumption taxes most often discussed include: (1) An import fee; (2) An exercise tax on gasoline and/or other petroleum products; and (3) A tax on the "BTU value" or energy value of all or most energy products.

As examples of previous proposals, in 1975 President Ford proposed a $2-per-barrel tax on oil consumption and a companion tax on consumption of natural gas equal to the BTU-equivalent of $2 per barrel (37 cents per thousand cubic feet). Congress did not adopt the proposal.

In 1975, a House Ways and Means Committee-reported proposal for a 23-cent per gallon gasoline tax was defeated by the full House, and President Carter's similar 1977 proposal for a 50-cent per gallon stand-by gasoline tax was likewise not enacted.

In 1980, President Carter proposed a $5 per barrel oil import fee which was to be passed along to consumers in the form of a 10-cent per gallon increase in gasoline prices. This, too, was defeated by the House.

In 1982, President Reagan proposed and Congress adopted a five cents per gallon increase in the Federal tax on gasoline and other motor fuels, the revenues from which flow mainly into the Highway Trust Fund for transportation programs. In his Fiscal 1984 budget, President Reagan proposed a $5-per-barrel contingency tax on consumption of both domestic and imported oil. The three-year, temporary tax proposal was made expressly contingent on certain budget and economic events coming to pass. The proposal was not adopted by Congress in its FY 1984 budget or tax legislation.

I think it would be fair to conclude that a tax on oil and oil products (with all of its complications) may be easier to construct than to enact.

The following is the Congressional Budget Office's review projections for various energy consumption taxes:

REVENUE

[In billions of dollars]

	Fiscal year		
	1985	1986	1985–1989
+$2/bbl oil import fee	2.5	3.7	17.0
+$0.05/gallon gasoline excise tax	3.2	4.4	20.7
+$2/bbl oil tax	5.7	8.3	39.3
+5 percent "value" energy tax on petroleum products, natural gas, coal, nuclear power, hydropower	10.7	16.1	82.9

In regard to the energy policy issues raised by energy consumption taxes, if you seek to reduce U.S. dependence on oil imports, an oil import fee is probably more effective than a gasoline tax or broad-based "BTU" tax, because an import fee makes oil imports more expensive to consumers relative to domestic energy sources. At the same time, the import fee would reward domestic energy production and conservation more relative to production of other goods and services in the economy not so "protected" by an import fee, as long as oil imports remain the imported fuel of choice at the margin.

However, an oil import fee also rewards other imported fuels at the expense of imported oil. For instance, Canada is sitting on sizeable reserves of both natural gas and falling water, and U.S. dependence on Canadian gas and electricity imports has substantially increased in recent years, even as real imported oil prices have declined. In addition, Algeria as well as Arab OPEC producers have expressed interest in reviving liquefied natural gas imports to this country. For this reason, it is unclear whether a sizeable tariff on imported oil would enhance our energy security or simply replace our oil imports with imports of other energy commodities such as natural gas and electricity. It would indeed be ironic if a fee on our oil imports, 3 of the top 4 suppliers of which are Canada, Mexico, and Venezuela, would only result in increased imports of other fuels from those same countries.

Also, the energy policy impact of an oil import fee may be no different than the impact of tariffs on other commodities: Where there is a "will" to get around the tariff, there may well be a "way". Thus, as far-fetched as it may seem, it would not be inconceivable for oil importers to seek to construct oil-fired boilers just outside our borders and then make arrangements to import electricity and other finished goods produced by the boilers directly into the U.S.

If our energy policy goal is to reduce energy consumption generally, a broad-based "BTU" or value-added energy tax probably would be more effective than either an oil import fee or a gasoline tax. A gasoline tax obviously would have a disproportionate impact on transportation energy consumption, while an oil import fee would disproportionately impact regions of the country dependent on imported oil, even while generally raising the marginal price of domestic substitute fuels such as domestic oil, coal, and natural gas.

However, the goal of reducing energy consumption for its own sake, separate and apart from reducing dependence on imported oil, has never been the goal of U.S. energy policy. Some economists have argued we should tax oil, gas and coal to reflect the inefficiencies of world markets in pricing the long-run replacement value of depletable resources. However, I have yet to find an economist who can supply me the prerequisite to such a tax: an accurate estimate of all the recoverable oil, gas, and coal left in the earth's crust. Absent such an estimate, a fossil fuel "replacement value" tax is difficult if not impractical to calculate.

Of course, to the extent any energy consumption tax reduces demand, it will also reduce domestic energy production, both in the short-term and the long-term. Although we do not know how much oil and gas is still to be discovered in the ground, we do know enough about the geology of oil and gas wells and coal mines and about the engineering of power plants and oil and gas pipelines to know that it takes a lot of money before we got our first barrel of oil, cubic foot of gas, ton of coal, or kilowatt of electricity into the hands of our customers. In the case of oil, gas and coal, we also know they are getting even more expensive every day relative to investments in other goods and services, as we push back the frontiers of exploration deeper into the earth and closer to environmentally senstive areas.

For this reason, an important consideration in any discussion of energy taxes must be the trade-offs between the gains in energy efficiencies which may accrue to energy consumers and the losses of economically recoverable supplies which may be suffered by energy producers. If we conclude the losses of energy production technology and "know-how" in this country are not offset by the value of gains in energy efficiency, then an energy consumption tax could be counterproductive.

If there is one thing we all learned in the first days following the 1973 oil embargo, it was this: you can quietly discuss national energy policy with all the experts behind closed doors without once hearing the question, "Is it fair?" But talk to one irate motorist stuck in a gasoline line without answering that question, and you have guaranteed yourself a lynch mob of thousands.

The equity issues raised by various energy consumption taxes are well-known to this Committee. As a general matter, excise taxes, of which energy consumption taxes may be one form, are regressive. This is especially true with regard to energy consumption patterns in this country, where low-income families apparently spend a higher percentage of their disposable income on energy than middle- and upper-income families. On the other hand, this regressivity is reversed to the extent that the fuel bills of low-income families are already subsidized by cash or in-kind assistance, such as Federal fuel assistance, public housing subsidies, lifeline utility rates, private charity, or other aid.

Energy taxes also disproportionately impact different regions of the country and different sectors of the economy. The Northeast is more dependent on heating oil and imported petroleum products than the rest of the country; an oil tax and especially an oil import fee would disproportionally impact that region. A gasoline tax would certainly affect the transportation sector more than other sectors of the economy, and would disproportionally affect transportation-related jobs such as in the trucking, tourism, and the airlines industries (if jet fuel were included). A broad-based energy "BTU" tax would be more equitable in its effect on energy users as a class, but would disproportionally affect energy-intensive sectors of the economy, such as manufacturing (steel, auto, chemicals). In addition, a broad-based "BTU" tax will always raise practical questions concerning what energy sources to include or exclude (wood? solar? geothermal?) and how to calculate the BTU value. We know from past debates over energy and tax legislation, such as gasoline rationing plans, the Fuel Use Act, or any tax bill we could name, the more ingeniously inclusive a regulation or tax, the more ingenious the efforts by those being regulated or taxed to legislate an exclusion for themselves in the law.

A final equity consideration relates to the indirect impact of energy consumption taxes on energy producers. Over the last ten years, led by the Members of this Committee as well as the Senate Finance Committee, Congress and Administrations of both parties have undertaken a vigorous review of the impact of our tax system on incentives for work, savings, productivity, innovation, and the formation of capital. One of the fundamental questions this Committee must address in reviewing energy consumption taxes is whether an otherwise fair and equitable tax on the consumption of energy commodities or goods is rendered unfair because it singles out energy commodities for taxation to the exclusion of all other commodities (such as farm products).

I claim no expertise on the efficiency of various energy consumption taxes. The experts at Treasury, the Joint Committee, and CBO are far better at estimating revenue impacts than I. However, I urge the Committee to keep one sentence in mind when reviewing the revenue impact estimates of various energy tax proposals: "Remember the windfall profit tax!" Remember that Congress when it enacted the Windfall Profit Tax Act estimated real oil prices would increase 2% per year. Treasury now estimates the tax will take in $57.4 billion through calendar year 1986—less than one-half the $126.5 billion Congress had anticipated. As our roller coaster ride over the last 10 years have proven, world oil prices, supply, and demand are notoriously insusceptible of accurate prediction. No one in 1968 could have foreseen the quadrupling of oil prices in 1973, no one debating the windfall profit tax in 1979 could have foreseen the 20% real decline in oil prices by 1984, and no one currently can foresee with any guarantee of accuracy the price path of oil through 1989. Moreover, the energy efficiency gains and stable domestic energy demand experienced by the U.S. economy during the current robust expansion have been unexpected. For these reasons, estimates of the efficiency of various energy taxes in raising revenues will remain slippery for the next several years, as world markets undergo an unpredictable transition from oil and gas to alternative fuels.

In summary, because of the substantial improvements in our national energy situation since our last major supply disruption in 1979, any energy consumption tax is far more likely to be judged by the American people as to its fairness and social equity than as to its beneficial domestic energy impacts. When they are not sitting in lines at the pump, American motorists care more about the price of gasoline than its country of origin.

Taxes on energy production

The taxes on energy production most often discussed relate to the current tax treatment of producers of oil and gas. This subject was the topic of two days of hearings held by this Committee's Subcommittee on Oversight, chaired by the distinguished Member from New York, Mr. Rangel, on May 5 and 6, 1983.

These tax provisions include: (1) The percentage depletion deduction for independent oil and gas producers; (2) The current deduction, or "expensing," of intangible drilling and development costs by oil and gas producers; and (3) The crude oil windfall profit tax, and its various exemptions and tiers.

In 1983, the Treasury estimated the revenue effect of percentage depletion at $1.465 billion in FY 1985, $1.6 billion in FY 1986, and $6.335 billion in FY 1985–FY 1988. The expensing of intangible drilling costs ("IDC's"), compared to separate cost depletion for all IDC's, was estimated at $625 million in FY 1985, $700 million in FY 1986, and $3.345 billion in FY 1985–FY 1988. Not taking into account the effects of the changes contained in the 1984 tax law, the windfall profit tax was estimated to raise, net of refunds and income tax reductions, $3.148 billion in FY 1985, $2.96 billion in FY 1986, and $11.282 billion in FY 1985–FY 1988. Differential treatment of independent producers and royalty owners under the windfall profit tax, such as through the reduced rate on 1,000-barrel per day production by independents, the independent stripper well exemption, and the royalty owner exemption, was estimated by Treasury to have a combined revenue effect of $700 million in FY 1985, $690 million in FY 1986, and $2,675 billion in FY 1985–FY 1988.

Any assessment of this tax treatment must begin with the testimony of J. Gregory Ballentine, Deputy Assistant Secretary—Tax Analysis, of the Department of Treasury in the May 5–6, 1983, hearings, who in pertinent part stated: ". . . prior to the past decade, the tax code generally favored investment in domestic oil and gas production relative to other industries. . . . Beginning with the Tax Reform Act of 1969, when percentage depletion allowances were reduced, there have been a number of tax changes that have eroded the overall advantage previously afforded to domestic oil and gas production. . . . Moreover, since enactment of the Economic Recovery Tax Act of 1981, the relative advantage provided to domestic oil production, compared to many other investments, by expensing of intangible drilling and development costs, has virtually disappeared. This is because 3-year and 5-year ACRS property is taxed almost equally favorably, when the benefits of the investment tax credit are included. Further, . . . the Tax Equity and Fiscal Responsibility Act of 1982 imposed additional limits on the benefits taxpayers derive from expensing of intangible drilling and development costs. Finally, the decontrol of oil was accompanied by the Crude Oil Windfall Profit Tax Act of 1980, a special excise tax on revenue from domestic oil production.

"As a result of all these changes, . . . it can no longer be asserted as a general proposition that the tax system favors investment in domestic oil and gas production."

I do not intend today to duplicate the testimony contained in the May 5–6, 1983, hearings nor do I intend to reopen the last 10 years of volatile debate over the implications of these tax provisions for national energy policy.

Suffice it to say that if the goal of our national energy policy is to encourage the exploration for and production of domestic oil and gas relative to oil imports, the tax code currently tends to encourage oil and gas production no more than it encourages investments in other enterprises, especially when the effects of the windfall profit tax are considered.

On the other hand, if our goal is to encourage the persistence of a large number (over 10,000) of domestically based independent oil and gas exploration firms who will continue to compete directly with major integrated oil and gas companies in the high-risk, high-return business of finding and developing new supplies of oil and gas, then the differential tax treatment of independent producers relative to the majors tends to achieve this goal.

Much has been debated over the question of whether domestic oil and gas exploration is more or less risky than other productive enterprises. However, there is no doubt that the geology and government regulation of oil and gas exploration today and in the future will require energy investors to allow long-lead times for the recovery of their capital. To the extent Congress in effect "pulls up the national energy tax tree" every few years to see if it has roots and then plants it in some other place, it is clear that our goal of increasing domestic oil and gas production will suffer.

In addition, to the extent we were to move toward a tax system which discourages oil and gas production relative to other economic activities, we may increase our capital exports and energy imports to and from countries which may be moving to encourage energy production, such as Canada.

In terms of equity, given the history behind the tax treatment of intangible drilling expenses and percentage depletion, it is clear that there is no consensus among the public as to whether such treatment is "fair" or "unfair." Even if most energy consumers perceive some "unfairness" in this tax treatment, very few outside the energy industry and financial markets are likely to have compared the relative value of IDC's and percentage depletion to the Accelerated Cost Recovery System (ACRS) for other equipment.

On the other hand, those who represent independent oil and gas producers have testified before this Committee that their members have concentrated their efforts in the petroleum industry's high risk activities, that is, exploration and development. For this reason, the independents have testified that the present tax incentives available to them relative to other energy producers and other investments are essential to provide a level of reward commensurate with the risks of their business.

Relative to energy consumption taxes, repeal of the differential treatment of independent producers would be inefficient in raising revenues.

In summary, it appears that the ACRS provisions for 3- and 5-year equipment have rendered non-oil and gas investments in such equipment generally no less advantageous than investments in oil and gas production, especially when the disadvantages of the windfall profit tax are factored in. On the other hand, it is apparent that most independent oil and gas producers, who drill the large majority of the exploratory wells in this country, consider their advantageous tax treatment relative to integrated producers essential to the continued availability of capital for such risky investments.

Although geologists debate whether the most promising areas for oil and gas exploration are those being drilled by independents or by the majors, Congress should probably consider the overall effect repeal of tax incentives for independent oil and gas producers would have on both competition in the industry and on the vigor with which oil and gas exploratory wells are drilled.

It would be a serious mistake if the various energy tax proposals now under review were to be considered in a vacuum apart from their substantial effect on national energy policy. As Congress moves forward to consider a tax system which is fair, efficient, and advantageous to economic growth, I urge you to weigh carefully any reactions your actions in tax policy are likely to have on our 10 years of efforts to achieve a national consensus on energy policy.

The task will not be easy, revenue raising measures never are. But I have confidence that the right balance will be found—My old friend Herb Stein recently said:

"There seems to be an anti-immune system in the political economy that causes it to reject elements that are incompatible with its effective functioning . . . What makes the economy function well is that a hundred million people get up every morning and go to work doing the best for themselves that they can. As long as that happens, the economy will be strong enough to resist policy errors within a considerable range, and provide time for correction.

"The key is to preserve the freedom of those hundred million people to get up every morning and do their own thing."

As we consider special taxes on oil and oil products, it may be well to remember that a great many of those hundred million Americans go to work every morning in their cars.

Mr. Chairman, I am prepared to answer any questions the Committee might have.

Mr. PICKLE. Mr. Zarb, thank you. Do you have a recommendation for the committee?

Mr. ZARB. At this stage, I haven't, Mr. Chairman. You must sense where my preferences lie. If you decide, and the Congress decides, that it is going to raise money, and it is going to raise money from consumers who use energy, then it is clear to me that a broad-based energy tax is more preferable than anything that is more selective.

I find a gasoline tax to be the worst. Very close to that is an oil import fee, standing alone. And then the third worst is an oil tax in general. If you decide that we need the money and the way to get the money is from energy, then a broad-based Btu tax would seem to me to make the most sense.

Mr. PICKLE. You mention a broad-based energy tax. More specifically, what do you mean?

Mr. ZARB. I mean that every Btu utilized in our economy would have to pay rent. This is a surcharge that users are going to pay in order for this Nation to do other things; initially, close the budget deficit.

Mr. PICKLE. Would it be the most difficult for the public to understand?

Mr. ZARB. No, I don't think so. I don't think at this stage the public would have difficulty understanding anything that is reasonably fair that strikes across the board.

What the public today have difficulty understanding, in the face of what appears to be plenty of energy and plenty of oil, is anything that will be disproportionate on particular users or particular parts of the country. While everyone finds it easy to talk about an oil tax today, I had my hands full when we imposed a tariff, because it impacted the Northeast in an unfair way.

So it seems to me that fairness has to be number one on the agenda if indeed we decided to go in the energy direction.

Mr. PICKLE. Well, it is going to be difficult for the Congress to make a decision. We tried the $5-per-barrel import fee, the $2-per-barrel import fee, and each time the Congress turned it down.

We have voted for a gasoline tax increase of 5 cents. To add to that may be even more difficult, particularly since the States are following suit and raising the gasoline tax, so it doesn't leave us many options.

What you are saying is that a consumption tax is bad, particularly if it is on energy, but if you had to have it, at least in the order of your preferences, the worst would be the gasoline, the next the import fee, and the least obnoxious would be a broad-based energy tax.

Mr. **Zarb**. The broad-based energy tax would be the most favorable of a bad lot of options. You are imposing a tax on the American people simply to raise money. The argument I have read that it is good energy policy to impose this tax doesn't hold up.

Mr. **Pickle**. We attempted to affect energy policy back in President Ford and President Carter's day. Whether we did or not is very questionable. The purpose now would be purely for raising funds.

Mr. **Zarb**. If those are the conclusions that this Nation needs the funds to reduce budget deficits, and energy must be an area that must make its contribution, then in my view, the best of a bad lot is a broad-based Btu tax, and call it that.

Don't try and justify it in terms of secondary effects on energy policy, because they won't hold up long term. They may work during some transitory period of our history, but not long term.

Mr. **Conable**. One of your colleagues was here the day before from Austria, suggesting if we put a tax on petroleum, it wouldn't affect petrochemicals all that much, that it was just a matter of trying to be a little more efficient, and he suggested a $5 a barrel tax, in effect.

Would you care to characterize such a comment?

Mr. **Zarb**. I think you can construct an oil tax that won't affect the petrochemical industry, and you make sure that they get some kind of rebates.

In the past certain industries were able to get exclusions or rebates as certain income levels were able to do it.

Mr. **Conable**. You wouldn't have to get into the rebate area, would you not?

Mr. **Zarb**. Yes, sir.

Mr. **Conable**. Only an oil import fee you would have to get into the entitlement a bit?

Mr. **Zarb**. But an import fee, the immediate effect of an oil import fee is to increase domestic prices increasing domestic revenue, and that changes the center of economic gravity, of certain industries.

As you have done, you have raised the price of oil and oil products as compared to energy as a whole. If we are going to have an energy tax, and they are a necessity, I would favor a broad-based energy tax.

Mr. **Conable**. There is a problem of administration of such a thing, and the establishment of a fair Btu equivalency standard, and so forth.

Mr. **Zarb**. There is, I have learned, however, and you have helped teach me that the first line of defense in these measures always is, "it is impossible to administrate". I have every confidence that there are enough technicians and computers in this country to deal with that issue, and even though it is complicated to introduce, it can be handled.

Mr. **Conable**. Well, Frank, tell us about OPEC. OPEC is having some problem of restraining production in a world where lots of the countries that belong to OPEC need the revenue. The strength of the dollar has meant that all the rest of the world has had to conserve and we have not.

Is OPEC going to be able to make it?

Mr. Zarb. Mr. Conable, they have passed the acid test in my view, they have gotten through the worst of their dilemma when oversupply was substantial, and you would normally find individual members of a cartel cheating like hell until they dismantle themselves.

That didn't happen, and one of the reasons I think they will make it is they are going to get support from non-OPEC members.

It is surely in the best interests of Great Britain and Mexico and Canada for OPEC to stay alive and I think they will.

Mr. Conable. What about Russia?

Mr. Zarb. The Russians, when it gets to their foreign exchange requirements, begin to look like capitalists, are not inclined to see OPEC go away.

Mr. Conable. They are seriously in need of cash, mostly for foreign food purchases. They do have an improved balance of trade.

Mr. Zarb. They may be cheaters, but they have to supply their client countries, and they would like to see whatever they send to the West return the highest amount of revenue. So while they might have to send Yugoslavia something under posted prices, when they send it to Western Europe, they would like to get paid in full.

Mr. Conable. Russia is dumping on its satellite some by charging an average price when oil prices are declining.

Mr. Zarb. While they may be charging them that, they are probably getting paid in pistachio nuts.

Mr. Conable. You said we will suffer in the future for some of the things that are not being done in the utility area at this point. Obviously, there is the issue of whether or not nuclear power is adequately inexpensive, so that we should be going ahead with that, or whether it is too expensive and we would be doing better to be producing more acid rain.

Are you saying that primarily because of the level of interest rates and the difficulty of financing utilities installations?

Mr. Zarb. Probably one single area where public policy has failed in the energy sector in the last 10 years. Our profile has improved a great deal since the 1973-74 crisis.

We have dealt with a bulk of our problems constructively. But utilities are part of local or State regulatory and political mess that national policy has not addressed.

Mr. Conable. They do tend to have a rather short time frame, if they can't flow the tax credits we generate here for capital investment through to the consumer currently, they feel they are not doing their jobs?

Mr. Zarb. We sat here in the central government and watched them disallow, putting construction work in the rate base in many of these States.

We stood by and allowed our nuclear program to become distorted and picked apart. Our consumers are going to pay more money in the late eighties and into the nineties, and we may have some shortages, given certain assumptions.

The problem has been a contorted regulatory mechanism at the local and Federal level that is completely screwed up, that is further aided and abetted in some cases by some pretty rotten management in the utility industry.

Mr. CONABLE. It is going to reap the harvest apparently. That is all the questions I have.

Mr. PICKLE. Mr. Zarb, you point out that the gasoline tax is the worst proposal, and that the import fee is almost as bad, and if you had to do anything, perhaps it should be a broad-based tax based on the Btu concept.

How do you answer the criticism we get sometimes that that approach might be a bit unfair, vis-a-vis the different energy commodities?

For example, the coal people said it is a great deal more expensive to mine coal, and the coal industry says finding oil and gas is not that difficult. Of course, the oil and gas industry disagree. Unless you put some kind of measuring unit with respect to value, would that be an unfair approach?

Could you correct that general conception?

Mr. ZARB. I expect you could try. I am not so sure that while I understand the nature of that criticism, that I could completely endorse it with respect to this argument.

I can't think of any tax that you would want to talk about or impose where we are not going to have an unfairness debate.

In this particular issue, if the Nation wants to impose a Btu tax and decides one of its side benefits is going to be to drive us towards utilizing less energy per unit of output and at the same time, promote the development of alternative fuels that are going to be necessary beyond the year 2000, then you can say that a Btu is a Btu is a Btu.

To the extent that your Btu tax on the ground has the net effect of becoming a fuels use, regulatory mechanism, that has to be corrected.

To the extent that you impose a tax which makes people move away from natural gas to coal, simply because of the tax, then that has to be adjusted, so while value has to be taken into consideration, I think availability, long-term price projections all most be put into the formula.

Mr. PICKLE. It may not be the most important thing, but we are just speculating, if we did go the route, what would be the fairest approach for a particular industry?

Mr. Jenkins, the Chair will yield to Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman.

Mr. Zarb, lets assume that there was no great need for revenue as far as the deficit. That takes a small step of faith, I guess, assuming that that factor was out of the way. Would you make any recommendations as far as changing any of the present tax laws as it relates to energy vis-a-vis other industries, or are they now basically on the same playing field as far as investment opportunities?

Mr. ZARB. Other than some technical issues that I may not be completely familiar with.

Mr. JENKINS. I am asking specifically from an energy policy area, would you recommend any changes or any as far as any imbalance?

Mr. ZARB. At the moment, I can't think of any. I would like to see us first complete the measures I outlined earlier—for example, eliminate controls where we still have price controls.

The fact it gets yanked around up here, has had a destructive effect on the ground. Every time you sit and talk about changing somebody's depletion allowance, some investor out there waits until you make up your mind before he makes the investment.

We have to stop yanking up the energy tree every year to see if it has roots.

Mr. JENKINS. Let me make another assumption that we will probably have to raise revenues, would you look to other sectors of the economy to impose taxation to the exclusion of the energy field? In the event that we have to raise revenues should we look at energy areas, and would they to be also included in that potential?

Mr. ZARB. You can't exclude energy. If you are talking about caviar, you could exclude energy, but agricultural products and other value-added concepts, you would have to include energy in your review, but I wouldn't seek energy out because you think you are improving the national energy policy.

Mr. JENKINS. When you speak of a broad-based Btu approach, you would mean into the field of electricity as well, which would apparently call for a tax to the consumer, residential consumer, on the amount of electricity they consume?

Mr. ZARB. Every Btu consumed, you would have to have adjustments because if we have energy-intensive exporting industries that use a lot of electricity, this Congress is going to have to decide whether it shouldn't let those people have some relief so they can compete in the international markets.

Every tax imposed will have those kinds of issues presented. The Btu is the most equitable, if one is to be imposed.

Mr. JENKINS. I think it would be the most difficult to pass.

Mr. ZARB. I am not sure, I have even seen—the most simple have huge difficulty passing. As I recall, Chairman Ullman's 23-cent tax was amended to a penny on the floor, and that was defeated, and that was a pretty simple tax.

Fairness is going to be an important issue this time around, and if you focus on one range of products affecting particularly one part of this country.

Mr. JENKINS. You indicated the utility companies for a variety of reasons are in some difficulties in the decade ahead. By imposing additional taxes, that is not going to be very helpful, I assume, to that particular industry?

Mr. ZARB. No, if that is all you do. It is certainly not going to be helpful. On the other hand, there can be some other mechanisms to provide them with some relief.

Mr. JENKINS. There is no real income tax liability basically for utility companies today. Most of them do not pay income taxes in actual dollars, because of the various credits, investment tax credits and others. Some of which I assume are not necessarily passthrough. Many times I have felt that in order to get out of that dilemma, it would be better to exclude companies from any income taxes.

But I know the utility companies fight that. Because I assume that would encroach upon their investment, their capital potential that is there that is not passed through to the consumer.

In other words, if we excluded utilities from income taxes in the condition that they are in now, it would hurt them even worse.

Mr. ZARB. By excluding them wouldn't have any effect at all on their total cash flow, and some of them, private companies, would be excused from income taxes for a long time, because of the tax loss carry forward.

Utilities have to be looked at case by case. I assume they have other sources of income and thereby come under a different heading, but the problems of utilities these days are substantially deeper than looking at their tax position.

They go to planning for the future, they go to their ability to construct plants on some efficient basis.

They go to the question of attracting reasonable management to run an important segment of our economy, and the way things stand now, many of them are not attracting good management.

Mr. JENKINS. That is also reflected in the public sector where huge numbers of partially completed nuclear facilities have been shut down at enormous costs to the companies and their stockholders and to the Nation's economy as well.

Mr. ZARB. Part has been bad management, and part has been bad national policy.

I can remember a state of the Union message in 1975 that called for 200 nuclear powerplants in the next 5 years, and that was a matter of patriotism to go out and construct a nuclear powerplant so lots of folks started to go out and draw up plans and dig holes until subsequent measures came along and penalized them.

That sector of our policy is still completely out of control and at some stage, beyond the election, this Government is going to have to be able to sit down and unscramble it.

Mr. JENKINS. Most of their projections apparently have been wrong, as far as the demand for electricity, and I guess TVA has closed down eight or nine.

Mr. ZARB. Their projections were initially wrong, they did not predict what higher price would do to the elasticity of consumption. They are wrong when they come and predict much lower growth rates. They don't want to have to go back and fight for another coal plant or another nuclear powerplant.

They would just as soon ride out the next 3 or 4 years. Only time will tell.

Mr. JENKINS. Thank you, Mr. Zarb.

Mr. PICKLE. Mr. Zarb, we appreciate your testimony. Do you have any other comments you want to add?

Mr. ZARB. No, sir, I sure don't. Nice to see you again.

Mr. CONABLE. Thanks for coming.

Mr. PICKLE. Thank you, Mr. Zarb, very much.

The committee stands adjourned.

[Whereupon, at 2:55 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF THE AMERICAN ASSOCIATION OF RETIRED PERSONS

The American Association of Retired Persons, the nation's largest aging organization with nearly 17 million members over the age of 50, welcomes this Committee's attention to the broad issue of tax reform. To the extent the various reform proposals focus public attention on the need for tax reform—even if that reform is simply a thorough review and evaluation of present tax preferences—this is a welcome endeavor.

AARP shares the deep concern of many regarding the huge budget deficits, estimated by the Congressional Budget Office to be $172 billion this year and expected to reach over $200 billion by 1989. Our membership regards reduction of these tremendous budget deficits as a major legislative imperative. At the same time that deficits are brought under control, however, equity must be maintained. Several legislative options have been presented to the Finance Committee as alternatives or additions to the current tax system which would not maintain equity for the elderly and other low-income segments of the population—the so-called "flat" taxes, including the Value-Added Tax (VAT), and the consumption tax plans.

The flat tax approach has been applied to various tax systems, including sales tax, consumption tax, and income tax systems. Proponents of a "pure" flat tax—a tax which would discard the current graduated tax rate in favor of a single tax rate, regardless of taxpayer income—argue that a flat tax approach, combined base broadening, is the best means to achieve equity and an understandable tax system. Tax rates would be lowered, under a flat tax system, by eliminating tax preferences.

Critics of flat taxes note that rates for lower and middle income taxpayers may increase if a flat rate approach is adopted, particularly if the flat rate system is intended to be revenue neutral. An exemption could be built into the system to protect low income persons and retain some degree of vertical equity, but such an exemption, because of the tax broadening measures, would have to be substantial.

Advocates of the flat tax approach admit that lowered tax rates for higher income persons will mean higher rates for lower income persons, but argue that the increase experienced only be temporary because increased economic activity will eventually further reduce the flat tax rate for all persons.

The VAT tax, which is an expenditure version of the flat rate approach, would assess a tax on the product at each stage in the chain of distribution. The tax, as a result, would be "hidden", effectively built into the product cost at the consumer level. (This differs from a sales tax, which is assessed only at the retail level.)

The consumption tax, which has been suggested with both flat and progressive tax rates, would assess taxpayers based on amounts spent, as opposed to amounts earned. This tax system is intended to increase savings and investment and thereby encourage economic growth. Although income would continue to be reported, the tax could reach consumption by requiring the taxpayer to report not only earnings, but also borrowing, savings account withdrawals, and assets sales proceeds. Amounts invested or saved during the taxable year could then be deducted. Under a consumption tax, many present deductions would no longer be available.

While simplification of the tax code is a desirable objective, the elimination of the progressive rate structure is not. Tax reform should not mean abandonment of the longstanding and sound principle that federal income tax liability should be based on "ability-to-pay". Flat taxes, and those based on expenditures would have a particularly significant impact, inequitably redistribute the tax burden. Those persons of lower income and who by necessity must spend most of what they earn would suffer a disproportionately heavy tax burden.

When a tax system builds from the idea that it is best to tax when a person needs to borrow or spend their savings, as would be the case under a consumption tax plan, it is those persons in the middle and lower income brackets who will carry the weight of the tax burden. Particularly affected will be the elderly who, no longer able to work, must spend their savings on living expenses. After a lifetime of saving and planning for retirement, the elderly are hit especially hard by the regressive nature of consumption taxes. Students, the unemployed, and families taking out loans for major purchases would also be severely impacted by a consumption-based plan. The recently released Joint Committee on Taxation's analysis of tax reform proposals noted that, under a consumption tax, the elderly, the unemployed, and parents putting their children through school would be worse off than under the present income tax.

Under the proposed sales tax or consumption plans, taxes would increase for those who are able to save less, and an additional tax burden would fall on persons who are currently liable for little or no tax because their incomes are so low. Conversely, those who spend only a small percentage of their income will find a decrease in the amount of their tax burden.

The regressive nature of a flat tax based on consumption is not readily avoidable through adjustment of the tax rates, as some proponents have indicated. Because the percentage of income wealthy individuals must spend is far less than what middle and lower income people must spend, graduating the rates to the degree needed to maintain the progressivity of the present system would be impractical.

Such adjustment would be made even more difficult because tax rates would have to start higher simply to have a revenue neutral system, since consumption will, by definition, always provide a smaller tax base than an income-based system.

Tax reformers must not lose sight of the fact that the principle on which our tax system is premised—that those who are most able to pay should pay more—requires that tax be applied to the power to consume, not actual consumption. A tax on actual consumption would lessen the tax burden on higher income persons simply because they need spend far less a percentage of income to maintain their standard of living, and would ignore the fact that higher income persons have greater access to investment opportunities and the financial security to take advantage of them. Merely utilizing differential rates or even exempting expenses for food, clothing, housing and other necessities from the tax would fail to alleviate this basic flaw in a consumption tax system. Additionally, exemptions for certain necessities will require an increase in the tax rate generally, thus those who must still spend a large percentage of their income may not be better off.

Not only do the elderly as a group spend most of their income—income that has already been taxed as it was being earned over a lifetime of work—but they often spend a disproportionately higher percentage of income on necessities. Statistics reveal that the elderly spend twice the percentage of income on fuel and utilities and medical care than the average taxpayer does, and over 5% more on food. According to Census Bureau figures on 1982 household income, nearly 50% of elderly households have an annual income of less than $10,000. With lower than average incomes, and higher than average expenditures on basic necessities, the elderly will be forced to shoulder a tax burden they can neither bear nor prepare for.

A number of more specific objections have been made to the flat and expenditure tax ideas. Initially, horizontal inequity would result under these plans because no differentiation is made for household size, as under the present system. Therefore a household with income identical to that of a single person would bear a much heavier tax burden since their expenses would be greater as a percentage of income.

The fact that the VAT tax is a "hidden" tax—added on through the stages of production and subsumed in the consumer's cost—means that raising such a tax rate would be politically much easier, as a change in such a tax would receive less attention since the tax is less visible. Such a system is more susceptible to political manipulation.

Although consumption tax proponents argue that their plans would provide incentives for savings, there is actually no clear evidence that savings will increase, as illustrated by the lack of any real effect on savings resulting from current tax breaks for capital income. Even if the amount of money available for borrowing does increase as a result of a consumption tax, the disincentive to spending that is created (since any money spent will be taxed) may well offset any stimulation caused by the consumption tax. The Congressional Research Service, in its June 1984-released study, warned that since savings, under a consumption tax plan, would no longer be subject to tax, people might perceive that their pre-consumption tax savings objectives could be achieved with even less saved. The study concluded that there was no clear evidence that any increase in aggregate savings would result from a consumption tax.

Finally, the equity argument that loopholes would be eliminated through utilization of a flat consumption tax plan cannot be totally accepted. In fact, such a plan would greatly expand the present tax breaks for savings and investment into what may be considered one enormous loophole to be enjoyed by those with the most available means to spend.

Besides the "pure" flat and consumption-type plans, to which the Association is strongly opposed, a number of other reform options can and should be considered. Broadening the tax base by eliminating those tax expenditures which have outlived their economic purpose is one option. Considering the size of the budget deficit, revenue loss from outdated tax expenditures should not be tolerated. Not only could needed federal revenue be raised, but the tax laws could be simplified and higher tax rates avoided. Elimination of unnecessary tax expenditures would also reduce the use of income for tax avoidance, thereby lessening the distortion of economic activity and increasing dependence on the value of the investment opportunity. Equity would also be furthered if many of these expenditures are eliminated. It is estimated that at present only 30% of taxpayers take advantage of tax preferences. Also, part of the intended progressivity of the present system is defeated because current exclusions and deductions represent a higher rate of subsidy to higher income taxpayers. Unless a tax preference is refundable, taxpayers with no income are not even able to take advantage of the tax expenditure.

In examining the tax code for unnecessary tax expenditures which might be eliminated, the Congress must be mindful of the tax system's current role as a tool for implementation of social and economic policy. Eliminating all deductions and credits in favor of a tax system with no function but to raise revenue changes part of the tax system's current purpose. Without certain incentives built into the tax code, money for many beneficial purposes, such as charitable contributions, might dry up. Thorough examination must precede any decision to eliminate a current preference since many serve useful social or economic purposes.

The modified flat rate plans under consideration would substantially reduce tax rates, while keeping those rates graduated, and would do this by eliminating most tax preferences. These tax simplification plans merit close scrutiny. The Association does, however, have several general concerns regarding the modified flat rate plans.

First, any plan which is designed to be revenue neutral avoids the enormous problem of the budget deficit, a problem which requires immediate answers. A second difficulty with the proposed plans is that no guiding principles are presented to explain the selection of the tax preferences the plans do incorporate. Without a clear outline, the fairness the authors of these plans would hope to achieve may not be perceived as such by the public. Also, the lack of a systematic set of principles leaves open the door to political maneuverings and continuing pressure for the inclusion of more tax perferences so that the very purpose behind these modified flat rate plans—to maintain revenue levels while simplifying tax regulations and lowering tax rates—would be defeated. However, those modified flat tax plans that maintain progressivity and simplify the tax code without being inequitable in the redistribution of the tax burden should be carefully studied and considered.

Nearly everyone agrees that tax reform is necessary. The Association supports efforts at reform, but welcomes reform only if it is achieved through careful deliberation, and not at the expense of those least able to bear a heavier tax burden. For these reasons, AARP strongly opposes those tax proposals—among them pure flat taxes, consumption taxes, and VAT taxes—which inequitably redistribute the tax burden to those with lower incomes, including the elderly, who are least able to afford it.

American Council on Education,
Washington, DC, September 28, 1984.

Hon. Dan Rostenkowski,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, DC.

Dear Mr. Chairman: On behalf of the American Council on Education, an association representing over 1,700 colleges, universities, and other organizations in higher education, and the associations listed below, we would like to take this opportunity to comment on the issue of general reform of our nation's tax code now being considered by the Congress. We respectfully request that this letter be included in the hearing record of the Committee.

As the Congress begins the effort to understand the implications of proposals to restructure the way in which we collect taxes in this country, we would respectfully urge the Congress not to lose sight of the fact that changes in the tax code could have profound though unintended effects on the way higher education in this country is financed.

The single most important impact concerns the incentives which the tax code offers for private donations. In 1982-83, total voluntary support for institutions of higher education amounted to $5.1 billion. Gifts directly from individuals represented 47% of the total ($2.4 billion) and gifts from living individuals, the category most responsive to changes in tax incentives, constituted 71% of individual gifts.

The dependence of private colleges and universities on such gifts is widely appreciated. What is less well known is that in 1982-83, gifts to public four-year institutions constituted 31% of total giving to higher education and grew from the previous year at a rate nearly three times the rate of growth of giving to private institutions. Increasingly, then, the health of many of our institutions of higher learning—public as well as private—depends on their ability to attract private donations.

We certainly do not contend that taxes are the only or even the dominant influence on individual decisions to give. We do know, however, that they are a significant factor. Economic studies consistently show that charitable donations vary directly with the marginal tax rate and inversely with the cost of giving. A ten percent rise in the next cost can be expected to cause at least a ten percent drop in charitable contributions. It also appears that this responsiveness increases somewhat with income, i.e., donors in the upper income groups, the groups that are most likely to contribute to colleges and universities, are even more sensitive to changes in the net cost of giving than are others.

This fact does not dictate only one approach to taxation, and we do not believe that a final judgment about the overall desirability of a flat rate tax, a value-added, or any other kind of tax should be governed solely by its effect on giving to higher education. At the same time, this important side effect needs to be recognized explicitly and thought needs to be given to how incentives for giving are to be maintained.

The American system of higher education is unique in the world because it has been able to utilize a combination of private and public resources to serve national goals. Preserving its quality and variety is crucial. Towards that end, we specifically urge the Congress: (1) To retain the charitable deduction in any program of tax revision; (2) to make the deduction applicable to the highest marginal tax rate, not simply to a lower base rate; and (3) to consider alternative mechanisms to stimulate private support of teaching and research in order to offset any reductions in the incentive to give resulting from decreases in marginal rates or other actions.

This letter is sent on behalf of: American Association of State Colleges and Universities; American Council on Education; Association of American Universities; Association of Catholic Colleges and Universities; Association of Jesuit Colleges and Universities; Association of Urban Universities; Council of Independent Colleges; National Association of College and University Business Officers; National Association of Independent Colleges and Universities; National Association of Schools and Colleges of the United Methodist Church; and the National Association of State Universities and Land-Grant Colleges.

Very truly yours,

SHELDON ELLIOT STEINBACH,
General Counsel.

AMERICAN FARM BUREAU FEDERATION,
Washington, DC, September 27, 1984.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: Much has been said about the need for and inevitability of tax increases to reduce the deficit. Farm Bureau disagrees. We believe that deficits and high interest rates are symptoms, not the cause, of the nation's financial problems. Rather, the growth of the federal government, particularly in entitlement programs, has caused most of the economic problems that the country has experienced within the past quarter century. If Congress looks toward tax increases to balance the budget and reduce deficits, we believe that its goal will not be achieved. More tax revenues provide only greater opportunity for the federal government to continue its fundamental problem: overspending. Higher taxes will not balance the budget.

The Committee has been conducting hearings on fundamental tax reform and the deficit. The American Farm Bureau Federation, which represents over 3 million member families throughout 48 states and Puerto Rico, offers these comments to the committee for inclusion in the hearing record.

Budget Policy: Freeze.—Farm Bureau believes that the country needs to embark upon a freeze-and-fix plan, a program to freeze cost-of-living adjustments in federal entitlement programs for a three-year period during which the necessary reform in the programs would be accomplished. Federal spending should be frozen at the previous year's appropriations level with the exception of interest payments and adequate defense funding.

Tax Policy: Encourage investment and economic growth.—Farm Bureau's tax and economic policies are attached for your information. These policies were developed by individual farmers and ranchers at county Farm Bureau meetings throughout the country. In summary, you will find that these recommendations state that the federal goverment should balance the budget through spending reductions, not tax increases. We consider a freeze on currently scheduled tax cuts to be a tax increase because a temporary freeze all too often becomes permanent. Farmers support constitutional amendments to balance the budget and to provide for a Presidential line-item veto. Tax policy should encourage private initiative and economic growth. Tax indexing should be preserved to fight bracket creep stemming from inflation. Tax proposals such as the flat tax should be studied to consider the effects upon farmers and ranchers. A value added tax should be opposed because it could adversely affect exports of farm products at a time when we need all the markets we can get. Capital gains treatment should encourage investment without creating loopholes. Tax reform to abolish loopholes should be considered to provide equity for all taxpayers.

Speaking of equity, we believe that Congress should take steps to erase the inequity that currently exists in the tax treatment of health insurance coverage. The inequity exists between self-employed people who must purchase their own health insurance without the benefit of any tax deduction and employees who received employer financed health care coverage as a tax-free fringe benefit. Farm Bureau has embarked upon a nationwide grassroots effort to gain support for S. 2353 (Grassley; R–Iowa) and H.R. 3487 (Latta; R–Ohio). These bills would provide a business deduction for self-employed people who purchase their own health insurance coverage. We believe that a deduction for one half of the health insurance premium is an appropriate way to correct the inequity rather than taxing the fringe benefit of other employees. Farm Bureau submitted comments on S. 2353 (H.R. 3487) to the Senate Finance Subcommittee on Taxation and Debt Management in July. The statement is attached for your use.

We encourage you and your staff to review these policies and call upon Farm Bureau if we can provide you with any other information.

Sincerely,

Robert B. Delano, *President.*

Attachments.

MONETARY AND FISCAL POLICIES

Farm Bureau strongly supports the continued reduction in the size of the federal government to stop inflation and increase productivity. This is our top priority. Balancing the federal budget will not be possible unless there are further substantial cuts in federal spending.

Farm Bureau supports an across-the-board freeze on all federal spending at the previous year's total appropriations level with the exception of interest payments on the national debt and an adequate defense. This freeze and spending limitation shall take priority over all other federal spending policies adopted by Farm Bureau.

Farm Bureau supports a freeze-and-fix program to reform all federal entitlement programs. The plan would require a three-year freeze, or moratorium (no increase), in all federal cost-of-living adjustments. If Congress does not fundamentally fix the entitlement programs within the three-year period, the freeze would continue until Congress accomplishes necessary reforms.

We support legislative or constitutional changes to give the President line-item veto power in appropriations bills.

We support a constitutional amendment to require the federal government to operate on a balanced budget each year. Only in extreme emergencies could this requirement be waived with the concurrence of the legislative and executive branches of government. A balanced budget should not be achieved by levying new taxes or increasing tax rates.

We support a constitutional amendment to restrict the spending authority of the federal government to a realistic percentage of the gross national product (GNP).

Off-budget federal outlays, including federal credit programs, should be brought on-budget as direct federal outlays. The Federal Financing Bank should be abolished.

The goal of monetary policy should be general price level stability. The Federal Reserve System should conduct a sustained, long-term monetary policy which will minimize inflation and deflation of prices. Should the Federal Reserve System fail to maintain sound discretionary monetary policies, we will support legislation to instruct the Federal Reserve System to achieve a specified rate of growth in the stock of money consistent with real economic growth, productivity and general price level stability. The Congress of the United States should conduct an audit and special public hearings on the Federal Reserve System.

Recognizing that a significant portion of federal spending is incurred through government contracts, competitive bidding should be encouraged. The use of "cost-plus" contracts should be minimized."

INCOME TAXES

Tax policy should be designed to encourage private initiative and economic growth.

We support income tax indexing.

We oppose a freeze or cap on scheduled tax cuts.

When income tax cuts are considered, reductions in tax rates are preferable to changes in the tax laws which reduce the number of taxpayers. We recommend that any tax cut be accompanied by a comparable cut in government spending.

Farm Bureau should closely monitor "flat rate" tax proposals to determine the feasibility and desirability of adopting this concept of income taxation and provide information on the flat rate tax to the state Farm Bureaus.

Internal Revenue Service investigative procedures should ensure that individuals are made aware of their rights and are notified of proposed actions prior to any action which might infringe on those rights.

We support legislation to preserve the confidentiality of federal income tax returns and to prohibit access to them and the use of information from them for any purpose unless such action is authorized by an appropriated court order.

Taxpayers should be given the option to treat investment in capital equipment for the abatement of air, water and soil pollution as a current expense for federal income tax purposes since such investments generally increase costs without increasing production.

Additional tax credits should be provided to industries which are required to comply with OSHA regulations, including standards more stringent than adopted at the federal level.

Since many taxpayers receive employer-financed hospital and medical insurance as a tax-free benefit, we recommend that other taxpayers be permitted an income tax deduction or credit for the cost of their health insurance premiums.

We favor continuation of the current tax-exempt status of the interest on state and local bonds.

We support an income tax credit for the parents of students enrolled in post-secondary education.

We recommend that changes be made in the income tax laws to allow farmers who have incurred losses due to declared natural disasters to be allowed to apply for the carry forward provisions of the internal revenue code until the loss is completely written off within a maximum of 10 years.

We oppose efforts to require farm employers to withhold income taxes from farm workers' earnings.

We oppose the taxing of interest income as it accrues. We recommend that, to encourage savings, the federal tax exclusion for interest and dividends be increased to $1,000 for individual returns or $2,000 for a joint return.

We believe farmers should continue to be able to select either the cash or accrual method of filing income tax returns.

The alternative minimum tax provisions of the Internal Revenue Code can result in a higher income taxes for farmers who have capital gains. This tax cannot be reduced by the investment tax credit. We support the repeal of the alternative minimum tax provisions.

We support repeal of the requirement for farmers to file 1099 forms; otherwise, seek to increase the reporting level from $600 to $5,000.

We oppose the use of agricultural land as a long-term, tax-sheltered investment by pension and profit-sharing funds.

We urge that the Internal Revenue Service abide by the decisions of state and local officials as to which agricultural lands shall be preserved in farm use through use of tax-deductible contributions of voluntary, private conservation easements.

We believe the Internal Revenue Code (Sec. 163) should be amended to permit farmers and ranchers, whether on cash or accrual basis of accounting, to deduct interest payments on farm loans as an expense item whether the interest payment is made with funds obtained from the original creditor through a second loan, an advance or other financial arrangement similar to a loan or from funds secured from a second creditor.

NEW FEDERALISM

We will support the shifting of additional responsibilities from the federal government to state governments if at the same time adequate access is made to the tax structure to allow for the financing of such programs by the states and a commensurate reduction is made in federal taxes.

INDEPENDENT CONTRACTOR STATUS

During the last several years the Internal Revenue Service has attempted to change several taxpayer classifications from independent contractor to employee. This group includes custom harvesters, carpenters, truck drivers, insurance agents, realtors, and other individuals traditionally considered independent contractors. We recommend that the present independent contractor status of the affected individuals be preserved.

INVESTMENT CREDIT

Farm Bureau favors maintaining the permanent status of the investment tax credit. We should work to secure the investment credit on facilities used in agricultural production.

We favor allowing investment credit on qualified used assets purchased by a lineal descendant but not on property that is repurchased by the previous owner.

We support an amendment to the Internal Revenue Code to provide an investment tax credit for horses used for breeding and working purposes.

CAPITAL GAINS

The tax treatment of capital gains should encourage investment without creating tax loopholes or discouraging the sale of property. The present law results in the taxation of "gains" which reflect, in part, a decline in the value of the dollar. We favor retention of the present minimum holding period.

We support an exemption from the capital gains tax when a farm is sold and another farm purchased within 18 months after the original sale.

When farmers are forced by government regulation or condemnation to sell land, buildings, livestock or other production items, they should be exempt from tax on the proceeds from such sale, provided they have owned the farm for five or more years and have derived at leased half their income from farming for at least five years. Property owners affected by eminent domain should be given the option of replacing the condemned property or reporting the taxable gain over a period of years.

We oppose proposals to apply the capital gains tax to the appreciated value of property transferred by reason of the death of the owner.

We support the present law with respect to capital gains treatment for sales of breeding livestock and forestry products.

We favor legislation that would reduce capital gains taxes for retiring farmers who sell their farms to farmers and finance the farms themselves.

FEDERAL ESTATE TAXES

We favor repeal of the federal estate tax. Pending repeal, federal estate tax exemptions or credits subsequent to 1987 should be indexed by the change in the Consumer Price Index.

We oppose efforts to freeze scheduled increases in estate tax credits (exemptions) before they become fully effective.

We oppose tax law or Internal Revenue Service regulations that provide for the recapture of estate tax benefits under special use valuation when heirs conduct necessary husbandry practices in their timber stands.

We will support legislation to permit a full "credit for estate death taxes" in determining federal estate tax liability where state death taxes are paid in installments.

SALES AND EXCISE TAXES

The retail sales tax should be reserved to state and local governments.

Federal excise taxes should be limited to: (1) Nonessentials; and (2) User taxes, such as the tax on passenger transportation by air and taxes committed to the federal Highway Trust Fund.

We support the exemption of agricultural aircraft fuel from the federal airport and airway taxes. We oppose the use of funds collected as taxes on aircraft fuels for purposes other than improvement of the nation's airways.

We oppose any additional tax on any farm commodity.

We oppose the adoption of a federal value-added tax.

We recommend that the excise tax on sales of well head oil be removed. Until this is accomplished, we support an exemption of 10 barrels of production per day for the royalty owner.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, SENATE COMMITTEE ON FINANCE, REGARDING TAX DEDUCTIBILITY OF HEALTH INSURANCE PREMIUMS FOR THE SELF-EMPLOYED, JULY 23, 1984

The American Farm Bureau Federation is pleased that the Subcommittee is holding hearings on tax policy issues surrounding fringe benefits. We note that the Subcommittee will be examining a number of questions including: "Are the existing rules concerning fringe benefits sufficient to ensure that all employees benefit fairly from the tax incentives?"

To assist the Subcommittee in developing "a full, fair hearing record on current fringe benefit topics" we have modified the question to reflect our concern about the equity of current tax treatment of health insurance premiums for the self-employed. This is an important issue for the nation's farmers and ranchers, most of whom are self-employed sole proprietors.

No group is more aware of the financial grip of high health insurance premiums than self-employed individuals, particularly farmers. Together with employees who do not receive employer-financed health insurance as a fringe benefit, the nation's 7.8 million self-employed business people must confront the serious inequity that exists in the use of income tax deductions to subsidize health insurance for other groups of workers.

While the Internal Revenue Code permits an employer to deduct employee health insurance premiums as a business expense (IRC 162) and treats the premiums as a tax-free fringe benefit to the employees (IRC 106), this type of tax treatment is not available to the self-employed worker. The self-employed person gets no deduction, but must buy health insurance with after-tax dollars. Currently, the only way a self-employed individual can deduct any amount of health insurance costs is if the premium is included in an aggregate of itemized medical expenses constituting more than 5 percent of adjusted gross income (IRC 213).

The denial of a deduction is apparently because health insurance is considered a personal expense rather than a business expense. Farmers and ranchers disagree with this short-sighted reasoning. Farmers, like other small business people, conduct business activities common to both employers and employees. The work environment of a farmer is often hazardous and not infrequently presents danger to life and limb from the use of heavy equipment and chemicals. Insurance is necessary to cover the costs of unexpected injury and illness stemming from the farming occupation. Health insurance is a cost of doing business that farmers as business owners cannot afford to be without. We believe it is a reasonable request that a self-employed person be able to deduct his or her insurance premium as a business expense.

There is also a question of equitable tax treatment among farmers who have different business organizations for their farming operations. A farmer who is a sole proprietor or in a partnership cannot deduct the cost of health insurance premiums as a business expense. However, if the farm is incorporated, the farmer can be classified as an employee of the farming corporation. The corporation, as the employer, can deduct the cost of health insurance as a business expense, and the farmer, as the employee, can receive the health insurance tax-free.

The vast majority of farms in this country are operated as sole proprietorships. The 1978 Census of Agriculture indicated that 88 percent of all farms with sales of $2,500 or more were sole proprietorships, 10 percent were organized as partnerships, and 2 percent were incorporated. These figures translate into approximately 2.14 million sole proprietorships operated by farmers.

The Subcommittee will be interested in the amount of health insurance premiums that farmers pay. In Iowa the 1983 monthly cost of comprehensive major medical group plan insurance with no deductible was $84.15 for a single person and $185.27 for a family. This equals $1,010 and $2,223 on an annual basis. In Michigan where age ratings apply, the annual family rate premium ($0 deductible) was $2,120 for insureds under age 45. The annual cost jumped to $3,150 for those between 45–54 and to $3,474 between 55–64. Even plans with deductibles are expensive. For instance, the 1983 family rate in Kansas for insureds age 40–44 with a $600 deductible was $778. The 1984 family rate in Texas for insureds age 40–44 with a $2,000 deductible per person per year is $1,320.

The rates illustrate the high out-of-pocket costs that farmers pay. Remember that they take no deduction for this cost although their in-town neighbors who work for a business that provides health insurance can receive the same coverage as a tax-free fringe benefit. Also, bear in mind that the Tax Equity and Fiscal Responsibility

Act eliminated the $150 deduction for health insurance premiums that all taxpayers could have applied against the cost of their health insurance premiums.

We believe that the following arguments support a legislative remedy to this problem:

EQUITY

As previously mentioned, the federal government is subsidizing health insurance for taxpayers receiving employer-financed health insurance at the expense of two other groups of taxpayers who cannot take advantage of current tax code provisions: (1) Self-employed taxpayers such as farmers and, (2) Employees who must buy their own coverage.

Even if Congress restricts the current tax-free status of employer-financed health insurance, the inequity will remain. Those employees currently receiving such benefit will continue to receive a certain level of coverage tax-free since all or a portion of the coverage will fall below the tax threshold amount of $840 per individual or $2,100 per family as proposed by the Administration.

PRECEDENT

The Social Security Act amendments of 1983 moved toward equity between employers and the self-employed in Social Security tax treatment. The new law provides that self-employed individuals will be able to take a tax credit for 1984–1989 against the self-employment tax that they must pay. After 1990, a new system of income tax deductions will be available to self-employed taxpayers. The deduction will be equal to one half of the amount of self-employment taxes paid for the taxable year.

A deduction or credit for the cost of health insurance premiums could be patterned after the credits/deductions enacted in the Social Security legislation.

RISING HEALTH CARE COSTS

Much has been said about the issue of health care insurance for the employed. The employed, as well as the unemployed, are hurt by rising health care costs, particularly those in hazardous occupations such as farming who may pay higher premiums because of higher risks.

HIGHER TAXES COMPOUND CASH FLOW PROBLEMS FOR FARMERS—HEALTH INSURANCE DEDUCTION COULD HELP EASE THE PROBLEM

Farmers have been hit recently with higher Social Security taxes, gasoline taxes, and excise taxes. An appropriate health insurance premium deduction would ease the increasing tax burden on self-employed people, help compensate for direct, out-of-pocket expenses for health insurance, and lead to more equitable tax treatment of health care coverage.

We draw the Subcommittee's attention to two bills, H.R. 3487 (Latta; R, Ohio) and S. 2353 (Grassley; R, Iowa), that would allow the self-employed to deduct one half of health insurance premiums as a business expense. Farm Bureau members across the country are working hard to gather support for these bills as well as other legislation that would eliminate the inequity that exists in the tax treatment of health care insurance. As of mid-July, H.R. 3487 has 136 co-sponsors and the Senate bill had seven co-sponsors. We believe that this legislation is a fair and reasonable response to provide equity for self-employed individuals.

On behalf of 3.3 million Farm Bureau member families, we ask you and the Subcommittee members to lend your support to this legislation.

STATEMENT OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

INTRODUCTION

The AICPA enthusiastically supports the efforts of the Senate Finance Committee to gather information and opinions on the appropriate direction of tax policy in pursuing the goals of greater equity and simplicity in the tax system. In fact, when the AICPA appeared during the Committee's hearings held on September 28 and 29, 1982, we urged the formation of a National Commission on Tax Simplification to explore the issues and we offered to participate in the effort.

To facilitate our expected participation, the Division established a Task Force on Tax Simplification to assimilate information and draw conclusions which we might share with Congress, the Treasury, our fellow tax professionals and the public.

We certainly agree with the Committee that the taxing system derived from your efforts—whether an improved version of the current law or wholly new—should be one which will be supported by a broad consensus. The AICPA wishes to participate in the debate leading to a consensus and submits this paper as a brief summary of our preliminary findings and recommendations. Our views derive from our perspective as professionals who work with the Internal Revenue Code constantly; and as daily, intimate observers of the reactions of literally millions of taxpayers.

PUBLIC PERCEPTIONS AND CONGRESSIONAL REACTION TO THE PRESSURE FOR CHANGE

We appreciate Congress' concern that a segment of the public perceives the present tax law as being harsh, less than fair and not simple enough. To the extent it exists, the reaction, we believe, is traceable to certain identifiable causes:

1. Economic conditions in recent years have been rigorous for many Americans. The individual has been faced with inflation, the buffeting of a series of recessions and "bracket creep"; and despite the tax burdens we all bear the word is out that the federal deficits will necessitate tax increases. It is then no wonder that some taxpayers adopt the attitude that if only "they" would pay their taxes, "our" taxes could be reduced.

2. Public officials, in appeals for budgets for their agencies or in debate on their legislation proposals, speak in pejorative terms of the "tax revolt." Publicity is given to the most extreme statements and some in the press and media echo them as irrefutable truths.

3. Tax legislation then is enacted in response to perceived popular demand for more fairness. But, the economic situation—for those who had demanded the changes—is not thereby relieved and the changes are not appreciated since inflation combined with "bracket creep" continues to beset them, and taxes remain high. As a result, before the ink is dry on one tax act, another is being formulated to accomplish the identical purposes: closing loopholes and curbing shelters. Ironically, the rapidity of the changes in the tax law causes some to be more fatalistic than ever, and louder in their complaint that they do not understand the law. The complexities added in the quest for fairness exacerbate their feelings that others ("they") probably are getting away with all of the tax advantages.

Despite the existence of the foregoing conditions, the AICPA believes that a fair appraisal of them and the public's reaction affords no support for the adoption of extreme solutions. Furthermore, we believe that public education and legislative restraint and change of emphasis will create a far better environment than presently exists.

AICPA members associate with enormous numbers of taxpayers at all levels of income. We gather their tax information and prepare their returns. We are factors in a collection system which is an extraordinary example of honorable self-assessment. We find that many Americans do accept the concept enunciated by Justice Holmes that "taxes are what we pay for civilized society." We believe that many more Americans would feel less imposed upon by taxation if responsible parties included in their public pronouncements that taxes represent a lesser percentage of the United States gross national product than is the case in most other industrialized nations.

We also believe that constant changes of the tax law disconcert all taxpayers. The AICPA recognizes that Congress' discernment of public perceptions is stimulating the ever-increasing number of legislative proposals. Nonetheless, it is also clear that taxpayers will better comprehend and deem more simple the taxes to which they are subject (and would better appreciate Congress' extraordinary recent efforts to make the law more fair) only if there is a moratorium upon change. We acknowledge that it is extremely difficult to say to one's constitutents: "Be patient. Give it two or three years, then you will see the effects of the positive changes we just made." But, until this approach is taken, every tax act—regardless of how painstaking was the effort to plug loopholes, stop abuses, and encourage compliance—will be a mere prelude to the next piece of legislation which necessarily will be more massive and complex than its predecessor. The AICPA believes that the cycle must be broken.

CONGRESSIONAL CONCERNS ABOUT FAIRNESS

We can also understand Congressional concerns about the common assertion that new laws are merely opening up new shelter opportunities. However, we believe that such concerns are not justified:

1. While we, as tax professionals may differ about details, we can confirm that recent tax acts—limiting deductions and losses, imposing minimum taxes, penalizing noncompliance, etc.—have tended to curb the abuses at which they were targeted.

2. Why are taxpayers tuning more-and-more to investments in areas of the economy such as real estate, and oil and gas, which traditionally are labelled of a tax shelter character? Why is this true after so much Congressional effort to curb over-indulgence in shelters by imposing penalties and reporting requirements and reducing write-offs? The answer, we believe, is found in pure economic motivation. The routine investment for the majority of Americans used to be the savings account and the stock market. The inflationary spiral of the last 15 years victimized the saver. The average taxpayer became convinced that the best investment he ever made was his house. Why should it be an unpleasant surprise that he, the average taxpayer, now turns to investments purportedly responsive to inflation, and which, incidentally, provide current deductions which relieve "bracket creep", and delay the imposition of taxes until sale.

The flow into such investments does not indicate the failure of Congressional efforts to curb shelters. Abuses have been addressed repeatedly over the last few years by ERISA, TEFRA, and the Tax Reform Act of 1984. All that is now needed is enforcement of the curbs you have provided.

COMMENTS UPON THE NEW PROPOSED SYSTEM GENERICALLY REFERRED TO AS THE "FLAT TAX"

The present tax law does embody the flat tax concept

We have referred positively to recent legislation designed to make the tax law more fair. In particular, we should mention the alternative minimum tax. The tax, at a 20 percent rate, falls upon income after adding back a comprehensive list of "preferences." Few deductions are permitted. Accordingly, we find somewhat hollow the contention that the United States must adopt a new broad-based taxing system in order to capture taxes from those failing to pay their fair share, when we as tax professionals know that the targeted alleged miscreants are now obliged to pay the alternative minimum tax. The rate of the AMT is approximately that of the proposed flat taxes. The AMT has been effective; few can escape its net. We realize the public-at-large may not yet be fully cognizant of this fact. But that is not justification for knowledgeable persons to act as if it does not exist.

Progressivity is foresaken by the flat tax

While the alternative minimum tax is not itself progressive, it serves the purpose of a backstop to what otherwise is a distinctly progressive system.

We know, as tax professionals, that there are vast numbers of taxpayers with high incomes who pay taxes in strict accordance with the progressive rate scales. For them, the flat tax, whether it contains one or several brackets, would be an enormous financial boon.

Flat tax advocates embrace fairness and simplicity as their dual tenets. But, flat taxes generally dispense with progressive rates in the interest of simplicity. Yet, progressivity has been viewed as synonymous with fairness in the American politically-oriented taxing system. Progressivity is a pure reflection of the age-old concept that taxation should be based upon the ability-to-pay. We are astonished that so manifest a benchmark of fairness as taxation by ability-to-pay is being seriously proposed for the scrap heap. We are confounded by the representation that such proposals will be more fair than the present progressive system. Somehow, by obscure rationale, the traditional values are being turned upside-down.

We foresee that, if the progressive rate scale is eliminated from the taxing system, in a year or two, there will be a severe political reaction from the middle-income taxpayer, and an irresistable demand for its reinstatement.

The flat tax will not fulfill expectations of redistribution of the tax burden

The particular beguilement for the public is the representation that, under the flat tax, taxation will be more fair. Many taxpayers instinctively consider that representation to spell relief, specifically: tax reduction. They believe that "we" will pay less, because "they" will pay more. But, advocates of the flat tax generally acknowledge that their proposals are: (1) revenue neutral; and (2) will not, to any substantial extent, re-distribute the tax burden among lower, middle and high income earners. We have stated above in comments on progressivity that, assertions to the contrary notwithstanding, the flat tax will favor many high income taxpayers. In fact, some proposals openly structure-in an increase of taxes on middle income taxpayers and a reduction for higher income taxpayers. Only a modification of the basic proposals to provide several graduated rates would foreclose this result. But, quite obviously, such modification sacrifices simplicity.

We must conclude that the middle income taxpayer who assumes that he will be a winner from re-distribution of the tax burden is in for a sad disappointment.

A more serious disappointment could be in store for all Americans if the new system is invoked as a stratagem to divert attention from an across-the-board tax increase. The flat tax proposals have the potential to severely impact upon the socio-economic system in the United States, as more fully discussed below. Therefore, it is imperative that the proposals should be considered in great depth purely to determine if their merits outweigh their deficiencies. They should not be pressed into service for any extrinsic political purpose.

The flat tax may not appreciably simplify the tax law

The AICPA doubts the validity of the contention—so basic to the appeal of the flat tax—that the average taxpayer's return will be significantly easier to prepare. Those expenses which now commonly appear on tax returns of most middle income taxpayers would continue to be deductible under prominent flat tax proposals. In addition, the base-broadening process would cause more items, such as various employee fringe benefits which are now excludable, to be reported as taxable income by the average taxpayer.

The problem for Congress, which would accompany the adoption of any entirely new system of taxation, would be to make the transition fair to taxpayers who made long-term commitments in reliance upon past law. We foresee the adoption of a new set of complex rules involving sets of effective dates, carryforwards, elections of alternative treatments, etc.

The underground economy will not surface

The AICPA challenges the assertion that passage of the flat tax would cause the underground economy to emerge and face taxation and regulation. To the extent the underground economy is comprised of organized crime activities, the assertion is patently baseless. To the extent the underground economy is made-up of persons who work "off the books" the rates which now would apply to their activities probably are less for most than flat tax rates.

To the extent persons operate underground to escape social security and sales taxes, governmental paperwork and regulation the solution is not the flat tax. The AICPA issued a report entitled, Underreported Taxable Income: The Problem and Possible Solutions, in January, 1983. We believe that adoption of its recommendations would result in contraction of the underground economy; but, we also believe that adoption of the flat tax would have no appreciable positive impact.

The economy would be profoundly affected by adoption of the flat tax

Advocates of the flat tax are heard to proclaim that the effect of the tax law upon economic decision making should be neutralized. However, the AICPA believes that the very act of extreme change such as adoption of a flat tax, will severely shock the economy as it is presently constituted. We would view this result as antithetical to the goal of neutralization. We do also believe that, in the absence of adequate study, it is impossible to reliably project the impact of such change upon the economy.

Countless long-term economic commitments by business and by individuals have been predicted upon the assumption of reasonable constancy in the tax law. Virtually every business and investment decision has been (and, we may add, will continue to be) evaluated in advance on the basis of its after-tax results. Even apparently slight changes in the past have shaken the foundations or promoted the growth of major segments of the economy. To illustrate the point:

Adoption of the Accelerated Cost Recovery System revived real estate construction throughout the country. When Congress recently contemplated extending the recovery period, industry representatives presented evidence to show that many projects would no longer be feasible. Congress responded by modifying the original proposed change.

Charities, and, of course, the beneficiaries of their good works, depend to a large extent for financing upon the subsidiary granted to contributors, particularly high bracket taxpayers, in the form of the charitable contribution deduction.

States and municipalities have established tax and expenditure levels with due regard to the deductibility of taxes on the Federal income tax returns of their residents. Furthermore, many states have tax systems which rely upon the Federal measurement of taxable income.

States and municipalities borrow at advantageous interest rates set by reference to rates earned after-tax on Federal and corporate bonds.

Millions of Americans decided to buy homes and seek medical care because the interest paid on their mortgages and their doctor bills were tax deductible and thus affordable.

The foregoing are only a few illustrations of the interlocking relationship of economic decisions and the provisions of the tax law. The elimination of credits and lowering of the tax brackets in which deductions and losses will be taken will be profoundly disorienting to the economy. In addition, the value of property typically acquired on credit such as personal residences, industrial plants and equipment, personal autos, etc. is bound to drop precipitously if mortgage interest and financing rates effectively rise because of Federal rate reduction.

The AICPA believes that the millions of taxpayers who would suffer the consequences of a change to a flat tax system, will not embrace the theory that tax effects upon transactions must be peremptorily neutralized.

The AICPA's recommendation of appointment of a National Commission on Tax Simplification postulates that the body would have the resources and intent to bring together authorities to study and report on the economic impact of the various new proposals. We do not believe that the broad consensus for a new tax system, which is sought by the Senate Finance Committee, can be developed in the absence of such a convincing report.

The ability of administrations and Congress to influence economic decisions through tax policy should not be abdicated

Over recent decades, the economy has faltered at times. Investments in plant and equipment by basic industries fell to critically low levels. The ability of American industry to compete in the international marketplace diminished because of a reduction of research and development expenditures. Unemployment rose. Investment in low income housing became insufficient to meet the demand. In each case, Administrations proposed and Congresses adopted tax incentives to meet the specific problem with salutary effect.

The flat tax proposals, in general, deny future use of tax incentives to stimulate the economy with the often needed precision. The AICPA believes that the flat tax will introduce simplicity at the sacrifice of the flexibility inherent in the present system. The consequences defy current estimation, and we believe this, too, should be the focus of study by the National Commission.

AICPA POSITIONS ON ALTERNATIVE PROPOSALS

The AICPA issued Statement of Tax Policy 2, Value-Added Tax, in 1975. The statement considers in depth whether an indirect tax such as a value-added tax or a retail sales tax should be used to provide for significant increases in federal revenues in lieu of increasing direct taxes (corporate and individual taxes). It concludes that an indirect tax at the federal level merits serious consideration.

At this time, task forces and committees of the Tax Division of the AICPA are restudying the questions addressed in Statement of Tax Policy 2, and have undertaken also to consider the advantages and disadvantages of consumption taxes as alternatives, in whole or part, to taxes on income. Conclusions on these matters will be forthcoming shortly.

It is abundantly clear, however, at this juncture, that a drastic change of the tax system is bound to affect United States citizens living abroad, foreign citizens living in or investing in the United States, and international business activities; and will necessarily disrupt previously negotiated tax treaty relationships.

Other matters of current concern to the Senate Finance Committee have been addressed by the AICPA. For example:

Statement of Tax Policy 3, Elimination of the Double Tax on Dividends, was issued in 1976. It came out in favor of integration of corporate and individual income taxes. The Division is in the process of re-examining its position, and will submit its conclusions to the Senate Finance Committee as promptly as possible.

The AICPA published a Study Document entitled, "Proposal For Complete Revision of Subchapter S Corporation Provisions," in 1978. Among other things the paper recommended expansion of the opportunities to adopt S Corporation status. The AICPA was pleased that many of its suggestions including the aforementioned were reflected in The Subchapter S Revision Act of 1982. We believe, however, that the goal of simplification would be further served if Congress amended the Act to permit more corporations to qualify as S Corporations.

THE AICPA'S PROPOSED PROGRAM FOR TAX SIMPLIFICATION

In the introduction to this paper, we referred to the formation by the AICPA's Tax Division of a Task Force on Tax Simplification. Preliminary conclusions have been reached both on the appropriate directions to follow in the legislative quest for simplification, and on actions which can be undertaken to heighten the public's comprehension of the tax system:

Appoint a National Commission on Tax Simplification. This would provide an ideal forum for all organizations and the public to express their views.

Impose a moratorium on substantial changes of the Internal Revenue Code. Fairness and simplicity tend to be incompatible goals, and Congress' efforts in recent years to make the tax law more fair have piled one complex provision upon another.

Focus future efforts to simplify the tax law upon the problems faced by individual taxpayers (with special emphasis upon the lower and middle income earners) and those faced by small businesses.

Consider an increase of the zero bracket to eliminate the complexities associated with itemizing deductions for vast numbers of individual taxpayers.

Analyze complex Code provisions to determine whether small businesses can be excluded from their application by the infusion of liberal "safe harbor" exclusions.

Expose proposed tax legislation for a reasonable period of time. Comments should be requested on the compliance problems faced by taxpayers if the provisions were adopted.

Rate legislative proposals on the degree of complexity they would introduce to the Code. Today, the revenue effects of proposals are set forth; in the future, the "complexity rating" should be given the same prominence.

Prompt the Internal Revenue Service to intensify the effort to simplify tax forms and instructions. The recent introduction of the popular Form 1040EZ is an example of a positive step which should be followed.

Provide additional resources to the Internal Revenue Service, to be applied to increasing taxpayer education and assistance in preparing returns.

Promptly after the passage of new legislation, the Internal Revenue Service should issue to the media clear explanations of those provisions affecting individual taxpayers and small businesses. The explanations should be in readily understandable question and answer form. In determining what questions are likely to be on the minds of taxpayers, the Service should elicit the opinions of tax practitioners.

CONCLUSION AND RECOMMENDATIONS

Our present tax system has developed over a period of 71 years. In its basic elements—the taxation of income, the availability of common deductions, the progressive rate scale—it is known by every individual. With reasonable efficiency, it extracts from the economic system the fuel to run the governmental machinery. The economic system itself, to which the taxing system inter-relates, is the most complex pattern of interacting elements known to man—perhaps only with the exceptions of the human body and the solar system. The innumerable decisions to tax in particular ways were based upon intensive examination of the economic consequences to the parties affected. Countless business, investment and personal decisions have been made in this country based, at least in part, upon the tax consequences.

Proposals to abandon the tax structure and adopt another should be approached with the same degree of caution as proposals to "improve" the human body through genetic engineering, or "improve" Earth's position in the solar system. We do not know the side effects: in the first case, a man might lose the power to speak; in the second, the Earth might hurtle away to oblivion. In the case of radical change of the taxing system, we may see vital industries starved for capital, charities abandoning their good works, foreign countries furious with us, and state governments on the federal dole. We also do not know whether this nation can afford to have future Administrations and Congresses without the power to use tax policies to influence the economy.

If the proposals are implemented, the decision-making processes will begin anew. Thousands of businesses will guess at the pending decisions of millions of individuals. When the inter-relationships will be brought into balance is pure speculation.

The AICPA wishes to offer the following recommendations and assurances:

We recommend that rather than have action for its own sake, all parties to the debate reflect upon what has been done by Congress in recent years to make the system more fair, if not more simple. We believe that facts should be proclaimed to counter public misapprehensions. The AICPA through its Tax Division would be pleased to participate in the effort.

The AICPA previously urged the appointment of a National Commission on Tax Simplification to the Senate Finance Committee, as mentioned in the introduction to this paper, and we hereby reiterate that recommendation. We believe that an indispensable ingredient of the Commission's final product should be a report upon the impact of all proposed changes upon the American economy.

The AICPA through the committees and Task Forces of the Tax Division will continue its study of the present system and the proposals for its revision. The comments contained herein are on the basis of preliminary analyses. We do wish to further clarify what we believe would be the effects of proposed changes upon the economic system. We would be pleased to share our findings with a National Commission on Tax Simplification, and assist in drawing conclusions which would be supported by a broad consensus.

The AICPA also recommends a moratorium on tax legislation. We strongly advocate simplification, and we have no desire to see more-and-more complex provisions added to the Code. We and the public need to be given the opportunity to digest the law. With comprehension will come a heightened awareness of the abundance of provisions making the law more fair. ERISA the Tax Reform Act of 1976, ERTA, TEFRA, and the Tax Reform Act of 1984 were monumental in scope and detail. Let the rules take hold.

The AICPA urges all responsible parties to actively discuss and promote numbers of individuals and small businesses from the Code's more complex provisions. And, then let us all join in revealing to the public that Congress has been responsive to their concerns while avoiding endangering the economic system upon which all taxpayers rely.

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE

In response to the Committee's request for testimony concerning major tax reform the American Petroleum Institute ("API") offers the following comments concerning taxation of the petroleum industry which we feel are important in considering tax reform. Some of these comments have been made to the Committee on prior occasions.

This presentation begins with a general overview of recent trends in the profitability of the oil and gas industry, its investment in new energy resources, and the effective tax rates it faces. It then turns to a tax issue of special importance to the petroleum industry—the broad issue of capital cost recovery. Congress has achieved significant reform in this area in recent years and it would be a step backward to tamper with the current system.

I. PETROLEUM INDUSTRY PROFITABILITY, CAPITAL EXPENDITURES, AND TAXES

A. Current business outlook

Oil consumption in 1983 in both the U.S. and other industrialized OECD countries has fallen about 18 percent below its peak 1978 level; and in constant dollars, current Rotterdam spot prices for Saudi Light are now about 45 percent below the heights reached during the 1979–80 oil crisis.

With falling oil demand and prices, the profits of U.S. oil companies have suffered. Among 24 major U.S. oil companies, 1983 average earnings were almost 28 percent below the peak level reached in 1980. Inflation has produced an even larger decline in real profits. Data available for 21 of the 24 companies show a profit decline of 24 percent in nominal dollars as against a drop of 70 percent in deflated dollars. The companies' return on investment, which typically has been about the same as that for industry generally, has dropped much faster than profits since the historical peak in 1980. More detail is provided in Appendix A. Investors are concerned that past expenditures made by oil companies in anticipation of high and rising prices are likely to be unprofitable as a result of possible further erosion of demand and price decline. Indeed, many high-risk energy ventures have already been abandoned.

Oil companies are reassessing and often reducing the scope of their operations. For the first time since the early 1970's, the total worldwide capital expenditures of leading U.S. oil companies turned down in 1982 and again in 1983. In addition, capital outlays on oil exploration, development and production turned down in 1982 and 1983. Even after the down turn, expenditures in 1983 were almost six times the 1968 spending level in current dollars. While expenditures in 1984 are expected to exceed the 1983 level, the rate of increase is not likely to be great for the remainder of the decade unless investment prospects appreciably improve. The reduced activity in the domestic oil industry is illustrated by an active rig count which decreased from 4,500 in December, 1980 to 2,415 in July, 1984, a decrease of 46.3 percent.

Expectations of risk-adjusted increased profitability provide the incentive for growth in oil industry capital spending, through depreciation of oil companies' cash flow and recourse to capital markets. As Appendix B shows, capital expenditures move closely with profits, but there is a lag because of commitments already made on projects having relatively long lead times.

B. Current taxes

In the face of receding demand, the taxes paid by oil companies have remained high. Total Crude Oil Windfall Profit Tax ("WPT") collections in the United States increased from $10 billion in 1980 to about $26 billion in 1981 and then, with falling crude oil prices, declined to $17 billion in 1982 and to a $12 billion annual rate in the first half of 1983. In combination with other federal and state taxes on oil output and income, the effect of the WPT has been to strip about 80 cents of each additional dollar of oil company revenue due to U.S. oil price decontrol.

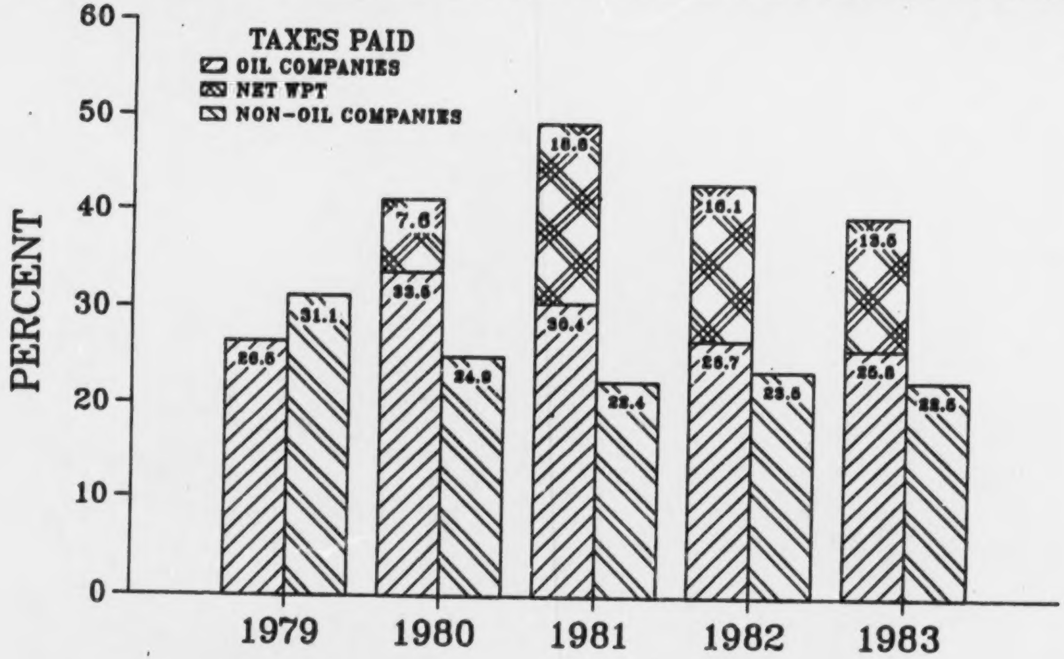
The WPT properly should be considered a part of the oil industry's federal tax burden even though it is an excise tax. Since a similar levy is not imposed on the price of foreign oil which competes with U.S. oil, U.S. producers are unable to pass the WPT on in higher prices. Inasmuch as the WPT is imposed directly on a portion of crude oil revenues, excluding consideration of the tax would significantly distort the industry's tax burden relative to that of all other industries which are not subject to such a tax.

Combined U.S. current federal income tax and WPT liabilities incurred by 24 leading oil companies grew to $23 billion in 1981 from $14 billion in 1980, before falling back to $15 billion in 1982 and $11 billion in 1983. Because U.S. income before these taxes rose at a slower rate, the oil companies' effective U.S. federal tax rate (current federal income taxes plus the WPT divided by income before such taxes) increased from 26 percent in 1979 to 41 percent in 1980, 49 percent in 1981 and then declined to 43 percent in 1982 and 39.3 percent in 1983. These tax rates have been significantly higher for oil companies than for non-oil companies each year in the 1980–83 period. These data do not reflect the practice of state and local governments of taxing U.S. oil producers more heavily than other kinds of companies. In particular, these figures exclude the billions of dollars of severance taxes and property taxes on oil and gas reserves paid by U.S. oil producers. In 1983, domestic taxes incurred by 24 leading oil companies totaled $30.2 billion. This includes $10.1 billion of motor fuel and other product excise taxes and over $20 billion of current U.S. federal, state and local income taxes.

Chart I compares the federal tax burden of leading U.S. oil and non-oil companies for 1979 through 1983. The oil industry graphs display two factors: the combined Windfall Profit Tax and current U.S. federal income tax burden as well as the estimated level of petroleum industry federal income tax had the Windfall Profit Tax not been enacted. Deferred federal income taxes (which arise primarily from the difference between tax and financial book cost recovery) are excluded. Deferred income taxes are highest for industries, such as petroleum, which are investing heavily in new plant and equipment. As the chart indicates, in 1983 the current federal tax burden for the leading petroleum companies was 39.3 percent compared to 22.5 percent for leading non-oil companies.

CHART I

COMPARATIVE FEDERAL TAX BURDEN OF LEADING U.S. OIL AND NON–OIL INDUSTRIAL COMPANIES



Source: American Petroleum Institute

Note: 24 Oil and 100 Non–oil Companies. Oil income taxes shown for 1980–1983 are what would have been paid without the Windfall Profit Tax, which is shown net of the income tax offset. In the WPT computation procedure, the WPT is deducted from income, and income tax is levied on the residual. If there were no WPT, the income tax would be higher– –as shown above. WPT is not shown for non–oil

Studies by the staff of the Joint Committee on Taxation, which do not include payment of WPT, revealed that 24 leading petroleum corporations paid 18.2 percent of their pre-tax U.S. income in federal income tax for 1982, while the average for all corporations for 1982 was 16.1 percent. Results for 1980 showed the effective income tax rate for petroleum companies was 31.1 percent, compared to 21.8 percent for all corporations. The 1981 rates were 21.7 percent for petroleum companies and 17.2 percent for corporations as a whole.

A study of the taxes paid by large domestic petroleum companies for 1974-1982 completed by the Petroleum Industry Research Foundation, Inc. in March 1984 confirmed that the petroleum industry has carried a heavy tax burden. For 1980-1982, the large petroleum companies paid federal income taxes at a three-year average rate of 26 percent compared to an average rate of 16 percent for the nearly 200 large non-oil companies included in the Joint Committee on Taxation's study.

Other studies have analyzed the impact of U.S. taxes on the incentive to invest and have concluded that major oil companies face higher prospective U.S. taxes than most other investors. In a report published by Harvard's Energy and Environmental Policy Center, in June, 1984, Robert C. Fry, Jr. found that the effective marginal tax rate, adjusted for industry-specific taxes and tax provisions, for major oil companies is 20 percent higher than the average marginal rates across all U.S. industry. Fry attributes this to the Windfall Profits Tax, the loss of the percentage depletion allowance for integrated oil companies, the impairment of the deduction for intangible drilling and development costs, and the state and local severance and excise tax burden of the industry. The Fry report states that any move to further reduce the proportion of exploration and development expenditures which can be expensed or to extend the Windfall Profits Tax will have a negative impact on future oil and gas development.[1]

Even though the oil industry's tax burden is among the highest in the country, some have suggested additional levies on oil producers. New or increased taxes would further reduce returns on investment and sources of funds to an industry already hurt by declining demand and prices. As a result, oil companies would find it less attractive to find and develop new energy supplies. Such a reduction would jeopardize the progress made in recent years to reduce the world's dependence on OPEC oil.

While oil demand has dropped sharply in recent years and may continue to drop in the years ahead, it is dangerously premature to conclude that U.S. energy problems have ended. Imports still account for almost one-third of U.S. crude oil requirements. The success that oil companies have had in reversing the decline in U.S. oil production and diversifying oil supplies worldwide ought not to be undone through the imposition of new taxes. The advantage of hindsight makes it clear that the U.S. energy crisis of the 1970's could have been resolved at far lower economic and political cost if only U.S. oil prices had been decontrolled earlier and U.S. oil producers had been taxed less.

Private investment, responding to relative rates of return, is the most effective method of allocating capital resources throughout the economy. Interference with this process diminishes the economy's efficiency. Thus, taxing petroleum even more than other industries hurts the efficiency of the economy and the prospects for a strong recovery. Furthermore, it would discourage energy investment just as the country is making encouraging progress in the quest for energy security.

II. CAPITAL COST RECOVERY AND INVESTMENT INCENTIVES

A. In general

The oil industry is particularly concerned about recent proposals to modify substantially the current system of capital cost recovery and investment in incentives. For example, the "Fair Tax Act" introduced by Senator Bradley and Representative Gephardt proposes repeal of the investment tax credit, repeal of current expensing for intangible drilling and development costs (IDC), and introduction of an open-ended 250 percent declining balance method of capital cost recovery which would significantly lengthen the present three- and five-year recovery periods for new investment in plant and equipment. It suggests a nominal 10-year period for petroleum exploration and production investment (upstream) and 18 years for refineries (downstream). Note that full capital recovery would not be achieved under this proposal, and there is no allowance for inflation. A system permitting the full pre-tax recovery of real capital costs is crucial to a healthy investment climate.

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[1] Fry, Robert C., Jr., *Industry-Specific Taxes and Effective Tax Rates*, John F. Kennedy School of Government, Report No. E-84-05, Harvard University, Cambridge, Massachusetts, June 1984.

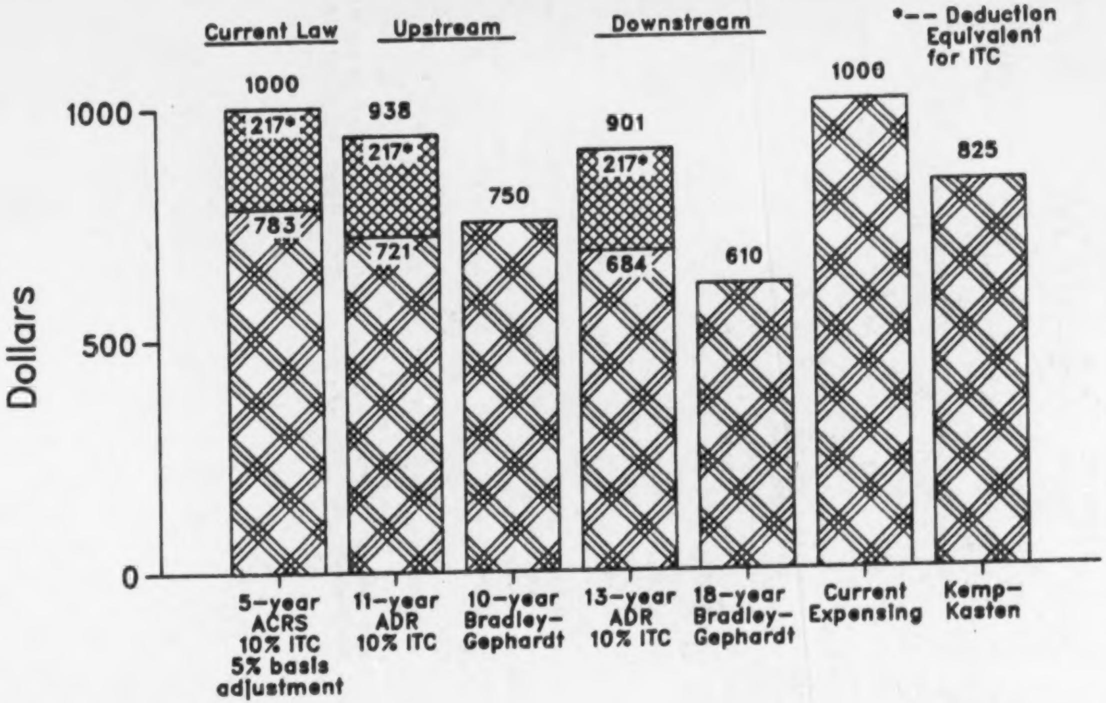
The capital cost recovery system relevant to most investment in the United States has been studied and improved over a number of years to move toward the goals of full recovery, simplicity, and economic efficiency. Its modernization began with the adoption of accelerated recovery methods in the 1954 Code. Recovery lives were reduced and recovery enhanced during the Kennedy Administration with the adoption of Guideline Depreciation. The adoption of Asset Depreciation Range (ADR) in 1971 and the Accelerated Cost Recovery System (ACRS) in 1981 further improved the system. It would be unfortunate to reverse this favorable trend and sacrifice future economic growth to obtain what at best may be only a temporary revenue gain.

Also during the Kennedy Administration, the Investment Tax Credit (ITC) was introduced as an incentive for investment. Its presence in the Internal Revenue Code helps offset the effects of inflation on depreciation allowances based on historical costs.

The ITC also helps offset the inherent bias of the income tax against savings and investment. The traditional income tax is biased against savings and in favor of consumption in that it, in effect, taxes savings twice: once when the income from which savings are generated is earned and again when the proceeds of savings are realized. If real capital costs are not fully recoverable, a third tier of tax—a tax on the capital, itself—would be levied on all capital investment. This bias against savings and investment is exacerbated by the corporate income tax, which imposes a fourth tier of tax on investment income in corporate form.

CHART II

Present Value of Various Cost Recovery Allowances and Investment Tax Credit (ITC) for $1,000 of Investment Discounted at 10% -- Assuming No Inflation



ACRS and current expensing are the two capital recovery systems which Congress considered in 1981, which ACRS adopted. Current law with five-year ACRS plus an investment tax credit of eight percent (without basis adjustment) is roughly comparable in present value to current expensing of capital investments at a real discount rate of 10 percent (with no ITC). At higher discount rates—as would be appropriate with inflation—the present system of ACRS plus ITC falls short of current expense equivalency.

For upstream petroleum investment, Bradley-Gephardt would result in a present value of future capital cost recovery allowances of only about 75 percent of the present value of either five-year ACRS (plus the ITC) or current expensing—assuming a 10 percent real discount rate and zero inflation. (See Chart II.) Thus Bradley-Gephardt would be a step back from either system. Bradley-Gephardt would reduce the present value of capital cost recovery to only 61 percent of the value of ACRS (plus the ITC) for recovery of new investment in the refining facilities necessary to meet future requirements for lead-free gasoline production.

The "Fair and Simple Tax Act" proposal introduced by Senator Kasten and Representative Kemp also proposes repeal of the investment tax credit and current expensing of intangible drilling and development costs. Even though it would retain ACRS, the Kemp-Kasten repeal of ITC would result in a present value of capital cost recovery for new investment of about 83 percent of either ACRS (plus the ITC) or current expense equivalency—assuming a 10 percent discount rate with zero inflation.

Any capital cost recovery system should be designed to neutralize the effects of inflation on the recovery of real capital costs. The eroding impact of inflation on recovery of capital costs would be exacerbated by lengthening depreciable lives. Moreover, reduction or elimination of the investment tax credit would diminish or eliminate the inflation offset provided by that provision. The longer it takes to recover capital costs, the smaller the real value of the recovery. Long recovery periods may result in recovery of less than the full real value of the capital investment, even if the investment tax credit were (improperly) counted as part of capital recovery rather than as an investment incentive.

For example, with a CBO-projected annual inflation rate of five percent, the present capital cost recovery system for assets in the five year ACRS category would require an effective investment tax credit of at least 11.4 percent (without basis adjustment) to achieve the incentive effect of current expensing. (See Chart III.) Present law provides only an eight percent ITC without basic adjustment.

CHART III

A COMPARISON OF ACRS PLUS ITC WITH CURRENT EXPENSING[1] UNDER NO INFLATION AND 5% ANNUAL INFLATION

No Inflation:

Year	Actual Value	Discount Factor P.V. @ 10%	Present Value	
1 ACRS Allowance	150	1.0000	150	
2 ACRS Allowance	220	.9091	200	
3 ACRS Allowance	210	.8264	174	
4 ACRS Allowance	210	.7513	158	
5 ACRS Allowance	210	.6830	143	
TOTAL ACRS ALLOWANCE	$1,000		$825	
Incremental Deduction necesary to maintain current expense equivalency[2]			$175	
ITC rate (without basis adjustment) necessary to match the incremental deduction at a 46% tax rate[3]				8.1%

5% Inflation:

Year	Present Value	Discount Factor P.V. @ 15.5%[4]	Present Value	
1 ACRS Allowance	150	1.0000	150	
2 ACRS Allowance	220	.8658	191	
3 ACRS Allowance	210	.7496	157	
4 ACRS Allowance	210	.6490	136	
5 ACRS Allowance	210	.5619	118	
TOTAL ACRS ALLOWANCE	$1,000		$752	
Incremental Deduction necessary to maintain current expense equivalency[2]			$248	
ITC rate (without basis adjustment) necessary to match the incremental deduction at a 46% tax rate[3]				11.4%

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1) At a 10% real discount rate

2) Calculated as difference between $1,000 and present value of total ACRS allowance.

3) $$\frac{\text{\$ Incremental Deduction} \times 46\%}{\$1,000}$$

4) (1.10) x (1.05) = 1.155
Real / Inflation / Nominal
Real / Rate / Rate
10% / 5% / 15.5%

In addition to ameliorating the effects of inflation, the current capital cost recovery system is a major advance toward the goal of simplicity. The Accelerated Cost Recovery System categorizes most annual capital investments in machinery, equipment, and special purpose structures into two recovery period classes (three and five years). There are also only two periods for structures (10 and 18 years). Short of expensing capital investment in the year incurred, it is difficult to visualize a notably simpler system of cost recovery that would at least partly protect recovery from inflation. Current expensing would, of course, fully protect the taxpayer's recovery of capital costs from the effect of inflation and would be the simplest system to administer.

B. Intangible drilling and development costs

IDC's are costs incurred for items which, in themselves, have no salvage value and are "incidental to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." Treas. Reg. 1.612-4(a). Such costs expressly include wages, fuel, repairs, hauling, supplies, etc., which are incurred in the drilling of wells, in the clearing of ground, and in the construction of derricks, tanks and other physical structures that are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

For income tax purposes, IDC's are capital in nature and, as such, would ordinarily be taken into account through 5 year ACRS and be eligible for the 10 percent investment tax credit. Under section 263(c) of the Internal Revenue Code and Treasury Regulations promulgated thereunder, taxpayers are permitted to deduct currently IDC's for oil and gas wells and wells drilled for geothermal deposits. Only the holder of a "working" or an "operating" interest (i.e., the interest which is burdened with the risks and costs of developing and operating the property) may currently deduct IDC's. Moreover, the election to deduct IDC's must be made by the taxpayer for the first taxable year in which such costs are incurred and is binding for all subsequent years. At the same time, the costs of all tangible equipment used in drilling and development activities are capitalized and recovered through 5 year ACRS with ITC.

Section 291(b), which was added to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982, reduced the amount of current IDC deductions by 15 percent for all corporations that are integrated oil companies. The 15 percent is allowed as a deduction ratably over a 36-month period, beginning with the month in which the costs are paid or incurred. Sec. 291(b)(2)(A). These amounts are not eligible for investment tax credit and are also subject to recapture on later disposition of the property under Sec. 1254. During consideration of this change the Senate Finance Committee adopted and the full Senate approved recovery of the 15 percent reduction in expensed IDC's using the five year ACRS schedule with the ITC, beginning in the year the property was placed in service. This is the same treatment afforded tangible well equipment and intangible costs such as transportation, labor, etc. involved in the acquisition and installation of other machinery and equipment or in the drilling of water wells for irrigation, etc. Although this rule was not adopted in the final version of TEFRA, its propriety is recognized by the election granted individuals to use five year ACRS with ITC. The Deficit Reduction Act of 1984 reduced the amount of current IDC deductions to 80 percent for corporations that are integrated oil companies. The remaining 20 percent is allowed as a deduction ratably over a 36-month period.

Corporations which are nonintegrated oil companies are allowed to deduct currently 100 percent of their IDC expenditures. Similarly, all individuals are allowed to elect to deduct currently 100 percent of their IDC expenditures. However, if an individual elects to deduct the full amount, he must include the amount of "excess intangible drilling and development cost" in determining tax preferences for purposes of the alternative minimum tax. Treatment as a preference item can be avoided if the individual elects to deduct the costs under a five-year schedule similar to ACRS and claim ITC under Sec. 58(i)(4); or ratably over a ten-year period under Sec. 58(i)(1).

The following chart summarizes the current tax treatment of IDC's:

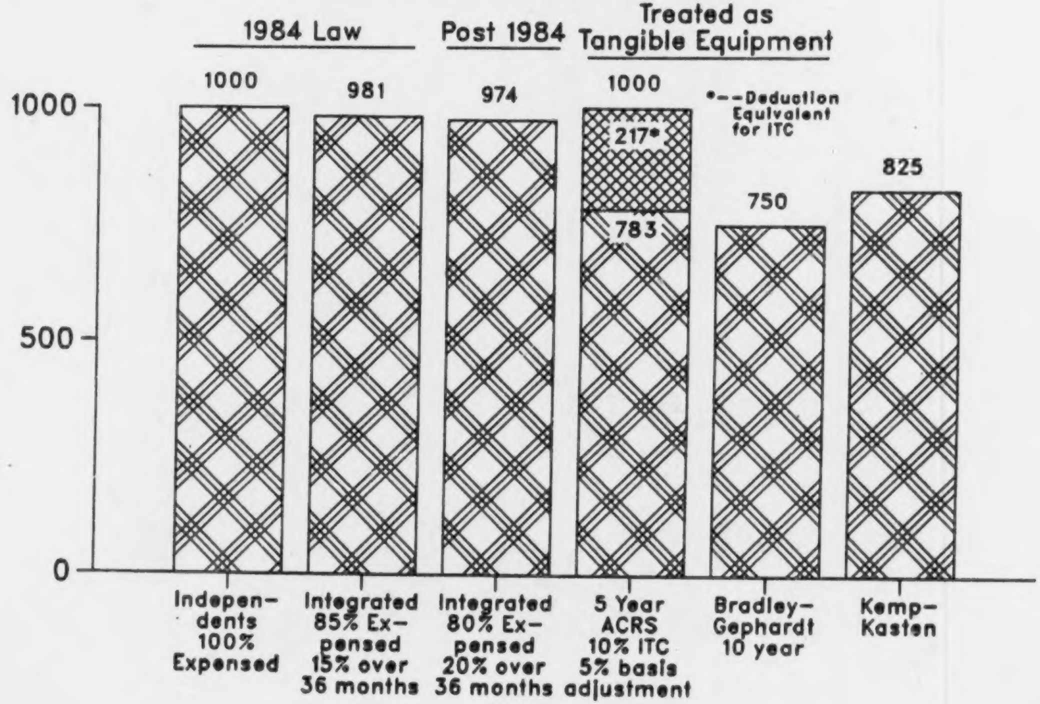
Corporations which are integrated oil companies	Corporations which are independent producers	Individuals
Currently deduct 85 percent of IDC's; 80 percent after 1984. Amortize 15 percent over 36 months—no ITC: 20 percent after 1984.	Currently deduct 100 percent of IDC's	Currently deduct 100 percent of IDC's. Tax preference item if currently deducted. May elect five-year ACRS with ITC if not a limited partnership interest. May elect ten-year amortization.

The tax treatment of IDC's was an outgrowth of the fact that many taxpayers considered the expensing of such costs to be an acceptable accounting practice. The treatment was also justified as a means of encouraging the exploration and development of our nation's oil and gas resources. The policy to develop domestic oil and gas resources still supports the need for rapid recovery of IDC's for tax purposes. Indeed, financial risks have escalated as the industry must more frequently drill in high-cost, hostile offshore and frontier environments.

Thus, the current deduction for IDC's substantially improves the financial attractiveness of oil and gas exploration and production relative to recovery over a longer period of time. Chart IV that the recovery of IDC's under Bradley-Gephardt is less favorable than under either Kemp-Kasten or current law. Costs recovered in the present are less burdensome than costs recovered in the future, especially in a period of high inflation or interest rates. Moreover, many members of the industry, both large and small, do not readily have the cash resources or borrowing ability to absorb the additional costs which would be caused by deferring deduction of drilling expenditures. For many taxpayers, the immediate cash flow generated by the IDC deduction can be an absolute prerequisite to participation in the industry.

CHART IV

Present Value of Various Cost Recovery Allowances for $1,000 of Investment in Intangible Drilling and Development Costs (IDC) Discounted at 10%



Current deduction of IDC expenditures has been a part of oil and gas tax law since the inception of the income tax. Its importance is widely recognized as it helps to attract investment into oil and gas development despite the high financial risks and costs. Oil and gas wells are expensive and have rapidly become more so as the search for new suppllies has extended into harsher environments and farther offshore in greater water depths. Only about one in five wildcat wells find oil in commercial quantities and many of those fail to cover their total costs. Numerous dry holes are encountered even in drilling operations in areas where oil and gas reserves are known to exist.

We would now like to review for the Committee the current status of the deduction for depletion and reiterate that cost depletion is an inadequate cost recovery mechanism.

C. Depletion

The Tax Reduction Act of 1975 added Sec. 613A of the Internal Revenue Code to eliminate percentage depletion on oil and gas production. Certain exemptions were provided, however, including a limited exemption for independent producers and royalty owners. API believes that percentage depletion was and remains an effective replacement cost recovery mechanism which encourages exploration and production of oil and gas by recognizing the high risks and the enormous capital outlays required to replace reserves today in the industry.

Depletion is a capital recovery mechanism. An owner of an interest in an oil, gas or mineral property incurs costs which, for tax purposes, are considered capital in nature. These include acquisition costs, such as lease bonuses, which are capital for fianancial and tax purposes and certain other costs, such as geologic and geophysical exploration costs, which are considered an expense item by accounting standards but are capitalized for tax purposes.

This capital must be recovered by "cost" depletion if percentage depletion is unavailable. Cost depletion is typically taken by the unit-of-production method—which limits current capital cost recovery to an estimate of how much of the property's total remaining output is represented by current production. Thus, when a barrel of oil is produced, it is ratioed with remaining reserves and multiplied by the adjusted tax basis of the property involved to determine the amount of the current depletion deduction. For a long-lived property, this method of recoupment is the slowest method of capital recovery available under current law. Real costs of capital invested have thus been "under-recovered" in recent years primarily due to the effects of inflation. By contrast, ACRS investors in manufacturing plant and equipment are able to recoup their investment within a minimum of five years after operation begins, even if the expected productive life of the investment is longer.

Congress first adopted percentage depletion in 1926 as a replacement for "discovery value depletion". Percentage depletion is designed to encourage drilling activity and to approximate the cost of replacing reserves currently produced. Depletion calculated on the percentage method allows the owner of the oil or other wasting natural resource to recover a percentage of gross income subject to certain limitations. In the case of oil and gas, the current rate of percentage depletion is 15 percent; which is substantially below the current value of reserves in the ground as a percentage of wellhead price (about 25 percent by some estimates).

Many of the underlying reasons for enacting percentage depletion initially, i.e. high risk and high cost, justify its continuation today. Risks remain high; the industry experienced dry holes on over 80% of all wildcat wells drilled. Furthermore, costs per barrel of new reserves have risen dramatically. Finally, and perhaps most importantly, in the past several years domestic consumption has exceeded domestic reserve additions.

The elimination of percentage depletion on oil and gas production of integrated oil companies in 1975 was, in part, a political reaction to the dramatic increases in oil prices that occurred after the Arab oil embargo. The retention of percentage depletion on certain limited production for eligible producers enables such operators to obtain the risk capital necessary to drill prospects which have been made uneconomic for non-eligible producers due to the removal of percentage depletion. The marginal prospect remains important in the outlook for potential additions to domestic reserves.

U.S. proved reserves steadily declined from 1970 through 1980 despite increased oil prices and record capital outlays by the oil and gas industry. Over the same period, the cost of replacing reserves rose dramatically. Inflation, which affects all business, contributed to the increase in geological and geophysical costs. Also, potential reserve additions were located in deeper zones or in otherwise more operationally difficult, and hence expensive, areas like deep offshore waters, the Alaskan

Arctic, etc. Finding costs escalated as wells were drilled deeper, the cost per foot drilled increased and reserves discovered per well drilled became smaller. While the rate of the increase in these costs has slowed, and indeed some of the costs have actually declined since the 1981 peak, the use of historical cost as a base for computing depletion simply fails to take into account the true cost of replacing existing reserves, especially when costs have increasd as they have in the last decade. The income generated by the sale of production from these reserves represents the consumption of a nonrenewable capital asset. As such, it is reasonable to consider the cost of replacing the reserves as the base on which recovery should be computed, rather than historical cost.

Rising prices through 1980 encouraged the oil and gas driller in finding oil and gas. Undoubtedly, however, some wells were not drilled and some production was forfeited by the removal of percentage depletion for integrated oil companies. In today's market, however, the demand for oil and gas products has declined, resulting in a corresponding decrease in price. Percentage depletion ameliorates the effect of this decline to some extent for independent producers. API believes that percentage depletion was and remains an effective replacement cost recovery mechanism which encourages the production of oil and gas.

III. CONCLUSION

Under current law, the oil industry's tax burden is among the highest in the country. New or increased taxes would further reduce returns on investment and sources of funds to an industry already hurt by declining demand and prices. Furthermore it would discourage energy investment just as the country is making encouraging progress in the quest for energy security.

The current capital cost recovery system, relevant to most investment in the U.S., which includes Accelerated Cost Recovery and the Investment Tax Credit, is not in need of reform. It permits taxpayers to recover real, not nominal, capital costs. In addition, it achieves the goal of simplicity.

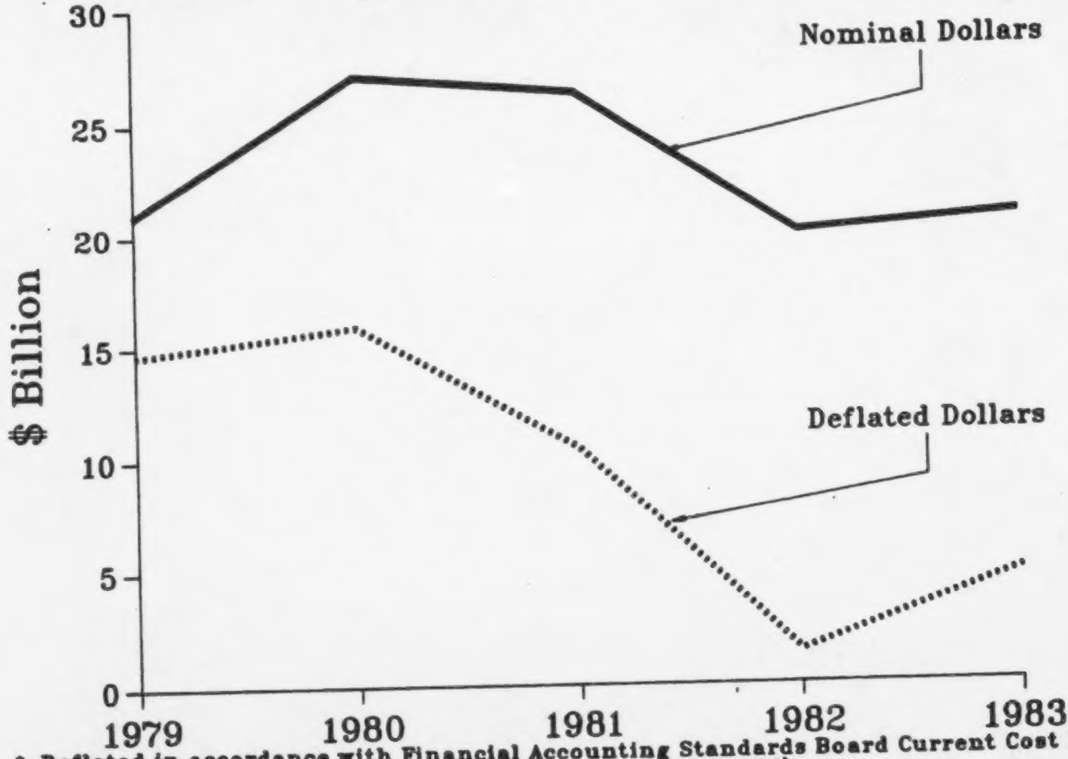
APPENDIX A

PETROLEUM PROFITABILITY

Chart V shows worldwide profits of leading U.S. oil companies for the period 1968–1983 in both current and constant dollars. when the real buying power of a profit dollar is considered, the 1983 profit figure of more than $21 billion is equivalent to $4.8 billion after adjustment for replacement costs (FASB current cost method).

CHART V

Worldwide Profits of 21 Leading Oil Companies In Reported Nominal and Deflated Dollars*

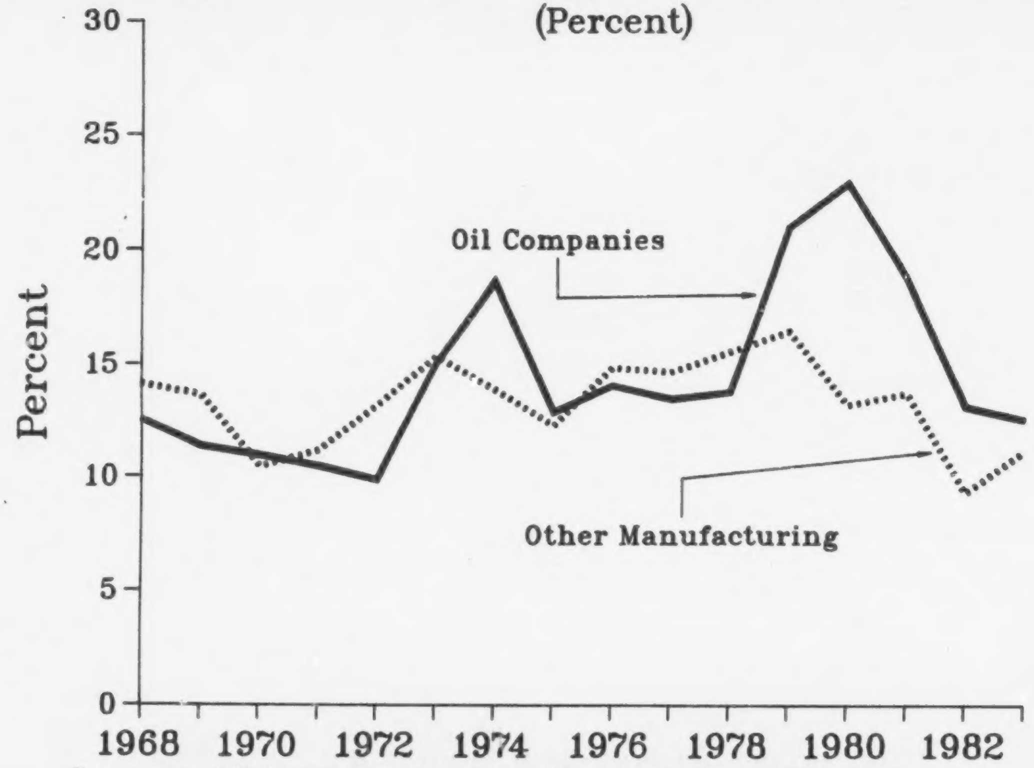


* Deflated in accordance with Financial Accounting Standards Board Current Cost Methods. (Replacement costs in average 1983 dollars, CPI-U, 1967=100)

To compare profits in the oil industry with profits of other industries we must adjust profits for the size of the industry. Rate of return on investment permits us to do this. Chart VI shows that return on investment in the oil industry has been about the same as that for other manufacturing companies. Real return on investment has declined sharply as a result of inflation. Chart VII details the nominal and constant dollar return on investment of 21 leading U.S. oil companies.

CHART VI

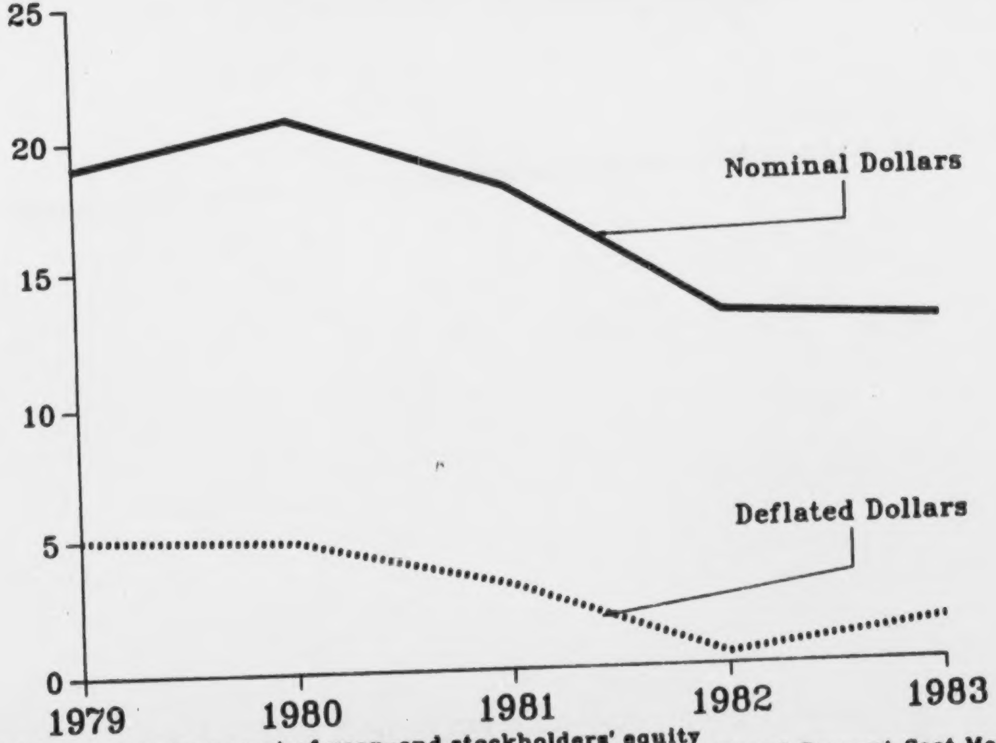
Worldwide Return on Average Shareholders Equity
24 Leading U.S. Oil Companies vs. Other Manufacturing



Sources: Oil Companies--American Petroleum Institute
Other Manufacturing--Standard and Poor's Compustat Services

CHART VII

Worldwide Reported Return on Investment of 21 Leading U.S. Oil Companies
In Nominal and Deflated Dollars*



* Net income as a percent of year-end stockholders' equity
Deflated in accordance with Financial Accounting Standards Board Current Cost Methods.
(Replacement costs in average 1983 dollars, CPI-U, 1967=100)

APPENDIX B

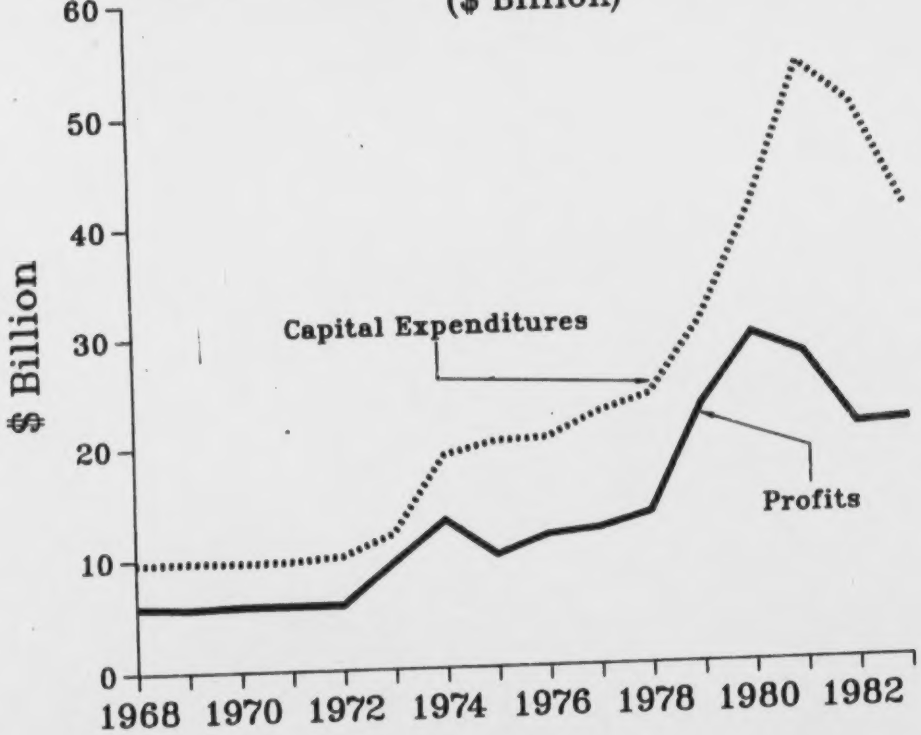
DISTRIBUTION OF CAPITAL EXPENDITURES

That oil companies do commit their earnings, supplemented by borrowings, to capital expenditures is shown in Chart VII. While profits were about constant during 1968–1972, capital expenditures were also constant. Beginning in 1974, petroleum investment more than doubled, reflecting higher profits.

CHART VIII

Worldwide Profits and Capital Expenditures of 24 Leading U.S. Oil Companies

($ Billion)

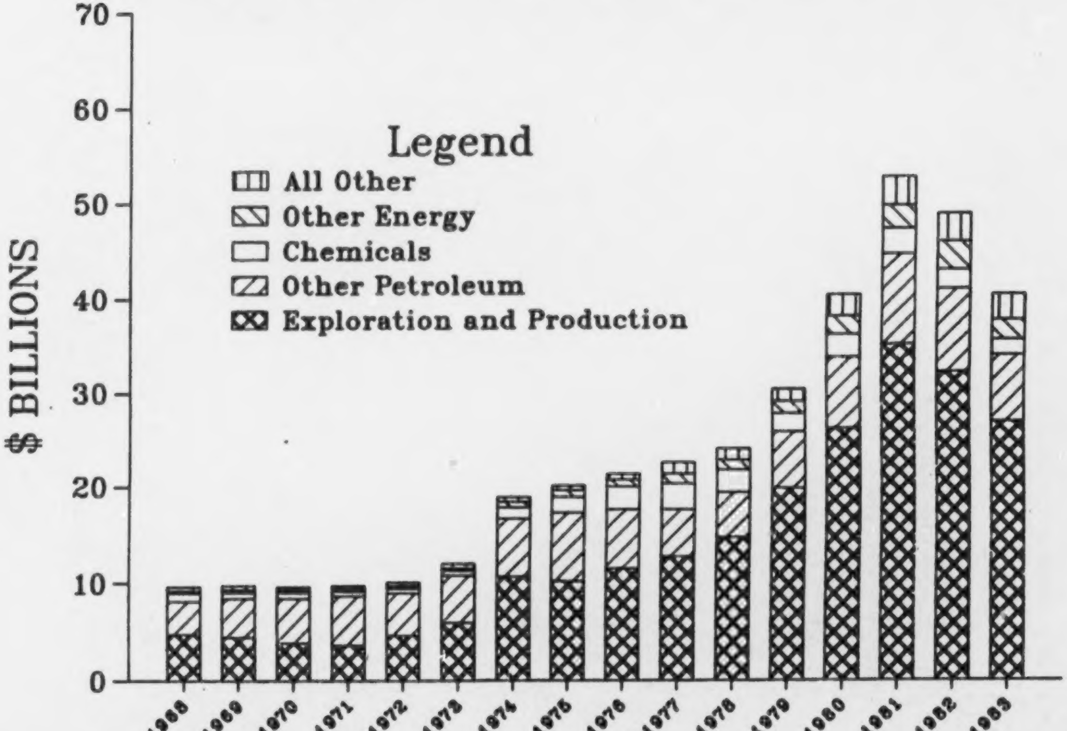


By 1980–81, profits were up by another $16 billion and capital expenditures were up by $26 billion. The larger absolute increase in capital expenditures was made possible by rising profits and return on investment. During 1982, capital expenditures were still $3 billion above the 1980–81 average even though profits were almost $8 billion lower, attributable to the lag resulting from investment in long lead time projects. Although profits rose marginally in 1983, capital expenditures fell by almost $9 billion, reflecting the continuing decline in return on investment and uncertainties regarding future prices and public policies.

The long-term growth of capital expenditures, noted above, as Chart IX illustrates, were primarily for petroleum and other energy sources. The spending has especially stimulated new oil production in non-OPEC countries. Production of crude oil has even been increased somewhat in the United States in 1982 and 1983, after a decade-long downward trend.

CHART IX

WORLDWIDE ADDITIONS TO PROPERTY, PLANT AND EQUIPMENT OF 26 U.S. OIL COMPANIES



Source: Energy Information Administration, U.S. Department of Energy

Statement of Staunton Calvert, Washington, DC

A REFORM OF THE FEDERAL INCOME TAX ON INDIVIDUALS

The principles underlying this proposed reform are familiar to tax administrators:

1. Fairness in distributing the total burden among the taxpayers is achieved by taxing at a single rate, determined for the year, the taxpayers' nonessential income (that is, income in excess of essential income.)[1]

2. Flexibility in determining the total amount to be collected through this tax exists in the setting of the year's rate—with consideration, on the one hand, of the collections from other sources and, on the other hand, of the total expenditures to be provided for in the budget.

3. This tax law is for revenue only; it embodies no attempts (real or pretended) to achieve economic or other social ends.[2]

4. Fairness and flexibility, essential qualities, are consonant with such simplicity that each taxpayer's effort in the determination of his tax liability is minimal.

We see, with the proposed law and its regulations in place, the Congress receiving from the Executive Branch, late in the tax year, proposals for amounts to be excluded from taxation (varying with the numbers of taxpayers' dependents). The Congress fixes the amounts by enactment.

With rare exceptions, the essential income is the only amount excluded from taxation. If a taxpayer has suffered a catastrophic loss or expense, this will occasion a conference between him and a representative of the Internal Revenue Service. The result, upon a determination that the loss or expense is excludable, will be to exclude it totally.

Now an estimate becomes available of the total of nonessential income of individuals—or "taxable income," or "tax base." The Congress determines the single tax rate (a "flat rate") to be applied to the nonessential income. On the left side of an equation are the revenues from all sources other than the income tax on individuals, plus the undetermined tax rate applied to the estimated total of nonessential personal income. On the other side of this equation are the items to be paid for—an adequate national defense, interest on the national debt, maintenance of a lean Federal Government, and then the arguable items. These last items consist of the debatable programs and the longed-for reduction of the national debt. So the setting of the year's single rate on personal income is a crucial action in budgeting—the determination of what we would like to buy, and what tax we must pay if we are to get it. (Unhappily, if the reduction in the national debt is not achieved, and instead there is a further increase, the amount of the new borrowing must appear in the equation alongside the revenues.)

The vital matters within these yearly decisions can be made known to the citizens by the members of Congress through their newsletters or other direct channels—perhaps through the Congressional Budget Resolution. If citizens are apprised of such processes occurring in Washington, they may well require equally cleancut processes in their state and local governments.

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[1] *Taxable income (the excess over essential income)*—Even the present tax law shields some personal income from income tax before taxing whatever income may be in excess of this. The shielded amount, evidently too small, is the sum of the personal exemptions and the deductions. Appropriate amounts to be shielded can be better determined: (1) all of the considerable expertise developed for finding poverty levels in order to deal with poverty itself is equally usable for the almost opposite purpose of identifying nonessential income as a residual; (2) poverty level, for an individual or group, is not sharply definable; (3) while there is danger, in the poverty situation, of determining too low a level and causing hardship or death, or of aiming too high and inducing people to remain unproductive, the tax situation differs pleasantly in that we can be willing to miss a little legitimate "tax base" by aiming too high but we don't want to tax (as apparently we do now) some of the essential income ("poverty income"); (4) finally, those who have more income than is essential, and may therefore be subjects for taxation, can be assumed to have mobility, so one set of figures can be applied countrywide.

[2] *Taxes for revenue only*—This essential principle is sadly forgettable. It was the centerpiece of the first public speech, in May 1977, of Jerome Kurtz as Commissioner of Internal Revenue, a speech devoted to "tax simplification." That expert's counsel was unheeded in Washington. Ronald Reagan used the idea well as a campaigner in 1980. In February 1981, just after his presidency began, evidence appeared that both political parties had turned from the principle. It still is ignored.

A common means for getting a major tax loophole enacted is to claim that the legislation will achieve an economic or other social benefit. Where a benefit is honestly sought through a tax provision, the result can be expected to prove inept or perverse. The general advice from the tax world is that, if you are convinced that a social benefit can be achieved by law, don't attempt to achieve it through tax law.

While the plan is neutral in the yearly decision whether the tax shall be heavier, lighter, or unchanged, it provides an unprecedented clarity in this determination. Thus its establishment can take us a long way toward a reasoned balancing of the budget at the earliest practicable time. During the persistence of inflation the plan stops the automatic increase in tax through "bracket creep" (there being no brackets) and obviates the consideration of "indexing."

Under the plan we can expect mechanization of all of the taxpaying process which is mechanical. The individual who will, or who may, be required to pay income tax will no longer be obliged to perform a high-grade clerical task, ro pay to have it done privately, but instead will be sent only a questionnaire. If the Internal Revenue Service needs information other than that which it has received from payers of salary, interest, dividends, etc., he supplies it on a "schedule" as at present; and this occurs if he operates a business or farm, or in the more complicated of the instances of capital gains or losses. The Service combines its bits of information on his incomes, tax withheld, etc., makes the computation, and sends him a statement ending with the tax due, and a schedule for payments—or with an amount of refund and a check for it. The taxpayer's option, on receiving this, is to acquiesce in the result or contest it. A purpose of the questionnaire, besides that of getting information from persons behaving legally, is to impose on those conducting all-cash enterprises, without filing tax returns, an evident choice of conforming—or incurring prosecution for a felony. For the great honest majority, the prospect for such relief from the old burden of filing is surely an uplift.

Such extensive change as is here proposed will engender legislative proposals for transitions from the old law. It probably will not always follow that a legislative provision is appropriate, but, of course, all serious proposals will have to be considered. Two ideas provide assurance: First, difficult transitional problems have been solved in the past, and there is useful experience for addressing new ones. Second, a you-can't-get-there-from-here position in relation to such a problem is unacceptable; the unfortunate tax provisions from the past cannot reasonably obstruct a revision, however substantial.

Present consideration of some later changes, possibly to follow the major revision, is appropriate. Premature involvement of some of these could endanger the effort as a whole. On the taxation of capital gains, the present law's position is between the extremes of taxing them as ordinary income (that is, omitting special treatment) and of relieving them of taxation altogether; arguments concerning any possible improvement on this position should be deferred. Another matter is the idea that winnings from lotteries which are operated by any government within our nation might be made nontaxable, to assure the position of that government in its competition against criminal gambling enterprises.

The greatly needed reform of the income tax on individuals will lead reasonably to decisions on other taxes, notably the income tax on corporations.

STATEMENT OF RICHARD H. FINK, PRESIDENT, CITIZENS FOR A SOUND ECONOMY

Thank you, Mr. Chairman and members of the committee, for the opportunity to present the views of Citizens for a Sound Economy. Briefly, CSE is a public-interest group whose main concerns are tax reform, retirement policy reform, privatization, and international free trade. Our organization includes two affiliates, the National Taxpayers Legal Fund and the Council for a Competitive Economy. NTLF has participated in the flat-rate tax movement and has about 35,000 supporters. CCE's membership comprises about 1000 principled businessmen who stand for a truly free market. They oppose government interference in the economy, including government subsidies to business.

I hope my testimony will inject an important perspective into the committee's deliberations, one that seems lost in the debate. Typical of college professors, I would like to recommend some readings that present the broader perspective in which specific tax reforms must be analyzed.

What is badly needed in the current debate is close scrutiny of the desirability of "revenue neutrality." Most participants in the debate take it for granted that the issue of tax reform is unrelated to the level of revenue any tax system should provide. They assume that changes in the tax system should not entail reductions in the amount collected. But federal spending is analogous to consumption spending; it does not fuel economic growth. Only savings can do that.

The economic well-being of the citizenry requires that resources be returned to the private sector for investment in the future. This can be done by lowering taxes, lowering government spending, and lowering the cost of government interaction in the economy, for example, by simplifying the tax code in order to reduce resource misallocation.

The present tax system has at least these major harmful economic effects:

1. It extracts too many dollars from the citizens, jeopardizing individual savings and investment plans, and increasing their dependence on government.

2. It is far too complicated; the cost of compliance is enormous because of the complexity and progressivity of the system.

3. It directs resources away from sectors that contribute to economic growth.

An appropriate flat-tax program would remove major barriers to sustainable economic growth. If the flat tax has a low rate that reduces tax revenues, it would: increase individual savings and capital formation; reduce the amount of resources allocated to avoiding and evading taxes; and reduce the misallocation of resources.

This leads to my second point. The readings I referred to are contained in an anthology I edited, Supply-Side Economics: A Critical Appraisal. I recommend and have included three articles from chapter 8, "Economic Growth: Alternative Views." The articles are by Lester Thurow of MIT, Stanley Kaish of Rutgers, who is also the Democratic Mayor of Springfield, NJ, and me.

It is noteworthy that despite the authors' differences in perspective, savings plays a critical role in their analyses of economic growth. All three believe that the level of savings and where those savings are channeled determine whether we have sustainable economic growth and general economic well-being, particularly for lower income families.

The case for the flat tax rests on the recognition that it would enhance savings, capital formation, and economic growth. If we are to avoid repeating past mistakes, Congress should take these factors into account when it reforms the tax code.

Thank you again, Mr. Chairman, for this chance to testify.

CHAPTER 8: ECONOMIC GROWTH: ALTERNATIVE VIEWS

SLOW ECONOMIC GROWTH

(By Lester C. Thurow)

Interest in accelerating economic growth has gone in and out of fashion. Along with the missile gap, it was one of the key campaign issues in 1960. The Russian growth rate exceeded that of the United States, and Nikita Krushchev was threatening to bury us economically and militarily. Faced with shortages of key materials and a sharp decline in America's productivity growth, accelerating economic growth has once again become an important issue.

The heart of the issue is productivity—output per man-hour. Our ability to consume ultimately depends upon our ability to produce. If we produce more per hour, each of us can have more purchasing power to buy the things we want. If productivity does not rise, our money incomes can rise, but it is not possible to have more real purchasing power. Often the issue is referred to as supply side economics. How can we increase the supply of goods available for private consumption, corporate investment, and government expenditures? To find an answer we must find a way to accelerate the growth of productivity.

To stop inflation recent administrations have chosen to tighten monetary and fiscal policies to produce idle capacity. Whatever the merits of idle capacity in the fight against inflation, it exacts a stiff price in slower productivity growth. With idle capital, incentives to invest diminish. There is little need for new, more productive facilities. Knowing that they do not need to expand, firms often cut back on research and development for new production processes. With high unemployment workers fear that technical progress will cost them their jobs and that alternative work will be hard to find. Consequently they push for more restrictive work rules to stop technical progress. The end result is a stagnant economy with a productivity slowdown on top of a basic productivity growth rate that already puts us at the bottom of the industrial league—with about one-third the productivity growth of Japan.[1]

Unless this decline can be reversed, and unless productivity can be accelerated to the levels being achieved by West Germany and Japan, it is only a question of time until we slip into relative backwardness. Few major countries have been brought down by foreign enemies; many have disappeared because of their internal failures. How are we to eliminate our failures and make our economy more dynamic that it ever has been?

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[1] Joint Economic Committee, *Manufacturing Productivity Growth, 1960–77* 5, no. 7, p. 1.

Here again the problem is not in finding policies that would significantly accelerate economic growth (there are many), but in adopting policies that would inevitably cause significant income reductions for someone. To increase investment someone's share of the national product must decline. Whose? Even more difficult is the process of disinvestment. We tend to think of economic growth in terms of investment and new products, but disinvestment is a necessary precondition. To have the labor and capital to move into new areas we must be able to withdraw labor and capital from old, low-productivity area. But every disinvestment represents a threat to someone.

Disinvestment is what our economy does worst. Instead of adopting public policies to speed up the process of disinvestment, we act to slow it down with protection and subsidies for the inefficient. If our steel industry cannot compete, we protect it. If our television industry lags behind, we negotiate "orderly" marketing arrangements to keep out foreign-made sets. If textiles are a low-productivity industry that should be located abroad, we adopt stiff tariffs to preserve a local industry. Our shipbuilding industry is an industry completely dependent upon subsidies. All of these actions are designed to provide economic security for someone, yet each of them imprisons us in a low productivity area. If we cannot learn to disinvest, we cannot compete in the modern growth race.

THE PROCESS OF ECONOMIC GROWTH

The process of economic growth can be compared to a complicated road-building operation. The first step is to scout the landscape and survey the terrain to see where you want to go and find the best possible routes for reaching desirable objectives. This is the role of scientific research. Generally scientific research proceeds far ahead of the rest of the road-building operation. We knew theoretically that an atomic bomb could be built four decades before we actually did it. At the moment, we know that fusion energy is theoretically possible (we can explode a hydrogen bomb), but several decades will have lapsed before we harness fusion reactions to generate electricity.

Well behind the frontiers of scientific research lies the domain of engineering research. The direction to go and the basic principles of how to get there are known, but a practical road must be designed. When engineering research has been completed, products and processes move from the domain of the theoretically possible into the domain of those processes that have been mastered and can actually be done. Using rockets for space travel was an idea whose origin is lost in the mists of history, but it passed the frontier of engineering knowledge when we were able to put a man on the moon and get him back.

While scientific explorations and engineering designs both are important, neither affects economic growth directly. The landscape may be known, the road can be built, but the road won't be built unless the economic benefits from having the road are greater than the costs of building it. Space travel is clearly feasible, but it costs so much that there is no economic demand for regular space travel to the moon. New knowledge only becomes relevant to our economy when costs have been reduced to the point that the information can produce goods and services, which we want, at a price we can afford to pay.

Further scientific and engineering research and development is necessary before a road will actually be built. Economic feasibility must be achieved. It is at this point that new knowledge starts to impact productivity. We build the road and start to use the new processes that produce better or cheaper products than we previously had. Our standard of living rises.

But an economy is not composed solely of new products and processes. It takes time and resources to shift to the new, so that any economy is a mixture of new, high-productivity activities and old, low-productivity activities. Some plants produce the newest products with the newest technologies while other plants produce old products with old techniques. The average level of productivity depends upon the relative weights in this mixture.

Our economy encompasses a wide range of productivities. Between broad industrial categories we had a productivity gap of almost five to one in 1977. Typically within each industry there is a range of productivities on the order of four to one. The result is a very wide distribution of productivities; but there comes a point when any product or process is so obsolete that it is no longer used. New products and processes drive old products and processes out of the economy. The old roads are torn up and abandoned.

This means that there are three factors that control the growth of productivity. First, how rapidly is the frontier of economic feasibility leading to higher-productivity activities. Second, how rapidly is the economy discarding low-productivity activities. And third, what is the distribution of activities between these extremes. Are most of our economic activities concentrated toward the high-productivity end of the spectrum or toward the low-productivity end of the spectrum? The frontiers of scientific and engineering knowledge are only relevant in that they are a distant road-building operation whose speed limits the long-run speed of movement toward higher-productive techniques and processes.

Already we are in a position to see some of the reasons why productivity has grown faster in countries such as Japan and West Germany. If a country is rebuilding from wartime devastation it will rebuild with new plants. Even if its best practice plants are no better than those in other countries, a large proportion of the plants will actually be located near the best practice frontier. This will give them faster productivity growth, even if they have no advantage in terms of their best practice plants.

Often people talk of this phenomenon as if it were better to lose a war and have your country blown up than to win a war and escape destruction. This is simply silly. To recover, the West Germans and the Japanese must devote a large fraction of their GNP to investment. The result is a much lower standard of living during the recovery period. Productivity grows rapidly but only at the sacrifice of real standards of living. If it were an advantage to have your country blown up, the winners could do likewise. They could junk their old plants (bomb them if you like) and build new plants. They don't because to do so is to reduce their standard of living. Consumption would have to fall both because production is down and because investment would have to rise.

Rebuilding countries do, however, have an advantage. Often countries find it difficult to get out of low-productivity industries and products even when economic analysis would call for it. Individuals lose their jobs and firms go bankrupt. Workers and firms lobby for government protection, subsidies, and regulations. If they are successful, the economy is locked into low-productivity operations much longer than economic circumstances would warrant. In the devastations of a postwar period, there is nothing to protect or subsidize, and no one could afford to do so even if there were. The economic losses that have been suffered can be blamed on someone else's army. The net result is that obsolete industries are not rebuilt. Disinvestment in low-productivity industries occurs at a much faster rate than it usually does.

DISINVESTMENT

While there are many voices calling for more investment, the process of disinvestment is even more important. Eliminating a low-productivity plant raises productivity just as much as opening a high-productivity plant. But doing so takes fewer resources. Large investments are not necessary. To close a low-productivity plant also makes it possible to move the workers and capital that have been tied up in this activity into new, high-productivity activities. With more men and investment funds, new activities can grow more rapidly. Paradoxically the essence of investment is disinvestment.

While we may have problems with research and development and with investment, our main failure lies in the area of disinvestment. We simply are not very good at accomplishing it. This is one of the places where the mixed economy has not worked. Capitalism is, after all, a doctrine of failure. The inefficient (the majority) are to be driven out of business by the efficient (the minority), and in the process productivity rises. Yet we are extremely reluctant to practice this part of our economic religion. This reluctance has a real moral basis at the level of the individual (a failing individual is a starving individual), but it has no moral basis when it comes to firms. Yet if anything, we have more programs to protect institutions (all of course justified in the name of protecting individuals) than we do individuals.

Low-productivity firms are often located in industries where the demand is stagnant or falling. This is partly due to the fact that new plants do not need to be built to meet new demands, but it is also due to a human problem. Dying industries simply cannot be managed as efficiently as growing industries. Growing industries attract bright aggressive managers who want to advance rapidly with their companies. In dying industries promotions are few and far between. Smart young managers know that they should be avoided. Who wants a job where the basic problem is to decide who to fire each day and where new, exciting investments are not happening? In a dying industry everyone is out to protect what they have rather than to build something better. They know that any gains in efficiency will simply result in more layoffs.

The result is a set of attitudes and actions on the part of both managers and workers that makes it virtually impossible to have rapid productivity growth in an industry where output is not growing or falling. The phenomenon can be seen all across America from railroads to schools. Efficiency falls as output drops. In the Boston area, where school enrollments are now rapidly falling, I know of no school system anywhere that has managed to reduce personnel nearly as fast as enrollments have fallen.

The basic problem in disinvestment is the desire each of us has to avoid the economic pains that are endemic whenever disinvestment occurs. Someone is worse off because of those disinvestments, and he or she has every incentive to appeal for government aid to stop or slow down the process of disinvestment. Regulations are adopted to stop railroads from abandoning noneconomic lines. Subsidies are used to keep an inefficient shipbuilding industry in business. Instead of shrinking with declining enrollments, schools discover special education and the need for more teachers. While it is easy to say that such things should not occur, each of us would be demanding the same protection if we were in the affected industries or communities.

PROCESS INNOVATIONS

Often the productivity problem is portrayed as if it were a simple problem of too little investment. If we just cut consumption and invested a larger fraction of our GNP, our productivity would be higher. One of the problems with this analysis is that more investment would now be occurring if it were profitable to do so. In most of the post-World War II period our economy has had the problem of wanting to save more than it wanted to invest. The result has been a series of recessions where demand (consumption plus investment) was below what the economy could produce. If anyone had wanted to invest more, there was no shortage of savings or production facilities, yet the investment did not occur. Taxes are often blamed, but our business taxes are no higher than those abroad. For some reason we just do not seem to have as many profitable investments.

Part of the explanation for this lack of investment can be seen in the context of what economists call *learning curves.* The learning curve phenomenon first came into focus in the production of Liberty ships and airplanes during World War II. After the plants were built and in operation, the number of man-hours of work necessary to build a ship or airplane fell rapidly as more and more ships or airplanes were built. The capital equipment did not change appreciably, but productivity rose dramatically.

This same phenomenon has been widely observed in civilian production. Following the introduction of a new product or the startup of a new plant, labor costs typically drop sharply for a few years and then more slowly, even though the labor force is working with the same capital equipment. Investments ultimately prove to be profitable or unprofitable depending upon the steepness of the learning curve and the pace of productivity advancement after the plant has been built. Based on engineering data, it is not easy to predict production costs since production costs are not constant over time. Multinational firms find that they can build the same plant in different countries or different regions and yet have very different productivity results.

The learning curve is related to the process of informal, on-the-job acquisition of skills and team productivity.[2] In the process of production workers learn and improve their individual job skills and learn to work together as a team. New workers are inferior to those who have been working on the job for some period of time, even though their formal education and skills may be identical. As a product is being built, new and better ways of building it are found with experience. Each innovation in the production process may be small, but the cumulative effect of many small improvements is often large.

The net result is a sharp rise in productivity as a plant goes down its learning curve. Labor costs of production at the bottom of the learning curve are often a mere fraction of those at the top. But the process is not automatic. It depends upon high quality management and a cooperative work force. If the work force is unhappy, it can stifle the learning process. If managers are incompetent, opportunities for new labor-saving procedures are missed. An early adoption of rigid work rules can freeze the plant into its initial productivity level and prevent it from proceeding down the learning curve. (This is an important factor in Britain where rigid work rules are usually negotiated before a plant goes into production.) The problem is to descend as far as possible and as quickly as possible down the learning curve. The firm that does so will have the lowest costs of production and the most profits.

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[2] Lester C. Thurow, *The Zero-Sum Society: Distribution and the Possibilities for Economic Change* (New York: Basic Books, Inc., 1980). See Chapter 3.

This creates an interdependence between capital and labor that is not recognized in the simple cry to raise investment. If the Japanese are able to generate a steeper learning curve than Americans, the same steel mill may be a good investment in Japan and a poor investment in the United States. To raise investment it is necessary to improve the characteristics of the labor market. New skills and higher earning depend upon new investments, but new investments also depend upon a cooperative work force. Simply raising the income of capitalists, with tax cuts that must be paid for with tax increases for workers, is unlikely to achieve either more investment or a higher growth of productivity. In generating more profitable investment opportunities, skill acquisition and a cooperative work force are as important as more funds to buy new equipment. Starting a class war is hardly the way to proceed. Imagine what those who believe that all work effort is dependent upon large income differences would predict about an economy where large firms give lifetime jobs, where relative wages are almost completely dependent upon seniority rather than personal skills and merit, and where income differentials are 50 percent smaller than in the United States. Yet the Japanese have the world's highest rate of productivity growth. *Why?*

The answer is found in the incentives this system provides for going down the learning curve. With lifetime employment and seniority wages, technical progress is not threatening. Whatever is invented, it is not going to threaten either employment or wages. With the typical worker getting about 50 percent of his or her wages in twice yearly bonuses that depend upon profits, a steep learning curve is of direct concern to each worker. Every worker has an incentive to maximize productivity by welcoming technical change, learning new skills, and contributing to industrial teamwork in a way that makes U.S. employers envious. Often this phenomenon is dismissed as a cultural one impossible to duplicate in the United States, but it probably has more to do with the economic incentive system than it has to do with culture. Faced with the same incentives, U.S. workers would respond in the same way. In any case, we need to find some system that achieves the same results.

RECENT DECLINES IN PRODUCTIVITY

While we need to do much more than simply reverse our recent slowdown in productivity, the slowdown is interesting since it sheds some light on what might be done to accelerate productivity. But more importantly, it vividly illustrates the complexity of the problem and the irrelevance of simple one-factor solutions such as more investment.

There is no doubt that the rate of introduction of new products and new processes has fallen. Productivity in the private business economy was growing at 3.2 percent per year from 1948 to 1965, at 2.3 percent per year from 1965 to 1975, and at 1.1 percent from 1972 to 1978.[3]

A wide variety of possible causes has been suggested for the lack of performance. Research and development expenditures are lower now than they were in the 1960s. It is often said that investment has fallen. We invest a smaller fraction of our GNP in plant and equipment than most of our industrialized neighbors. Government health, safety, and environmental regulations may have made growth more difficult. The age-sex mix of the labor force has been shifting toward inexperienced (low productivity?) workers—women and the young. Stop-go economic policies and inflation have made investors reluctant to invest. Uncertainty has risen. Workers are alienated and less cooperative in producing productivity gains. With high unemployment and more fears about job security, work rules have become more restrictive. The list of possibilities is almost endless.

Two of the commonly suggested causes simply do not fit the facts. Research and development expenditures are down from 3 percent of the GNP at the beginning of the 1970s to slightly more than 2 percent at the end of the 1970s, but productivity started to fall in 1965 well before the downturn in R&D expenditures.[4] In addition, as we have seen there is a long-time lag between R&D and productivity. A lack of R&D in the 1970s may cause productivity problems in the 1980s, but it does not explain productivity problems in the 1970s much less than in the 1960s. Our industrial neighbors have also consistently invested less in R&D than we.

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[3] Council of Economic Advisers, *Economic Report of the President*, January 1979, p. 226.

[4] U.S. Department of Commerce, *Statistical Abstract of the United States* (Washington D.C.: U.S. Government Printing Office, 1978), p. 622.

Plant and equipment investment cannot explain the decline because it is up, not down. When our productivity was growing most rapidly (1948–65), plant and equipment investment averaged 9.5 percent of the GNP. Productivity growth fell after 1965, but investment rose to 10.2 percent of the GNP from 1966 to 1972. Productivity growth took another fall after 1972, but investment stayed up at 10.1 percent of the GNP from 1973 through 1978, despite the sharpest post-World War II recession.[5] Perhaps we should invest more, but declining investment is not the source of our problems.

If you analyze the pattern of productivity growth, it is clear that large productivity gains are associated with any surge to full employment. Conversely productivity growth falls as the economy moves away from the full utilization of men and machines. This occurs because we have a large proportion of overhead labor and plants designed to operate most efficiently at capacity. Managers, research departments, salesmen, maintenance workers, and the like either cannot be or are not cut back proportionally when output falls. The result is a drop in productivity since more man-hours are now necessary to produce a unit of output. Conversely when output rises toward capacity. we do not have to expand the overhead labor force. Output goes up, but overhead man-hours do not go up, and the result is a rapid gain in productivity.

About 30 percent of our productivity slowdown can be attributed to idle capacity. In our efforts to fight inflation, we have deliberately chosen to hold the demand for goods and services below what the economy could produce. Whatever benefits this may create in terms of less inflation, one of the costs is a slower rate of productivity growth. This part of the productivity problem will be cured only when we solve the inflation problem or decide to fight inflation with some other technique.

About 40 percent of the decline can be traced to a shift in the mix of goods and services being demanded and produced. If there are substantial differences in productivity among industries, as there are, the mix of output demanded by consumers, business, and government can have a substantial effect on the rate of growth of productivity. If demands are shifting toward high-productivity industries, the economy's productivity will grow rapidly. If demands are shifting toward low-productivity industries, the economy's productivity will grow slowly.

In the United States there are large differences in productivity among industries. In 1977 a man-hour of work produced $4.92 (1972 $) worth of output in services and $23.59 worth of output in finance. This is a range of almost five to one.[6] Despite what is often believed, manufacturing productivity ($8.44 per hour in nondurables and $8.42 in durables) is not much above that of the economy as a whole ($8.09). High productivity industries are finance, wholesale trade, utilities, communications, and mining. Low productivity industries include services, retail trade, construction, and agriculture.

With such wide differences in productivity, the mix of goods and services demanded can have a large effect on productivity. For a substantial period of time after World War II, the mix effect was enhancing productivity. We were leaving low-productivity industries, mainly agriculture, and entering high-productivity areas. But this process ended around 1972. The mix of goods and services demanded started to decelerate the rate of growth productivity rather than accelerate it. The sharp movements out of agriculture ended, and services (another low-productivity industry) started to grow much more rapidly.

From 1948 to 1972 agriculture, an industry whose productivity was 60 percent below the national average in 1948, reduced its demand for labor by 500 million man-hours per year. Every worker leaving agriculture and entering the urban economy meant a sharp rise in productivity, and there were millions of such workers. But by 1972 this process had essentially ended. Productivity was still rising rapidly in agriculture, but agriculture had become so small that it no longer was releasing millions of workers. After 1972 annual reductions were down to 50 million man-hours per year. Large amounts of labor were no longer being released from a low-productivity industry.

Quite the reverse was now occurring. Another low-productivity industry, services, started to grow much more rapidly. While less than 30 percent of the additional man-hours added to the economy from 1965 to 1972 had been in services, 47 percent of all man-hours added to the private economy after 1972 were in services. Since service productivity is 40 percent below the national average, every worker moving into services represented a sharp cut in average productivity. What had been a sharp shift toward higher productivity became a sharp shift toward lower productivity.

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[5] U.S. Department of Commerce. *Survey of Current Business* 59, no. 7 (July 1979): 26.
[6] Ibid., pp. 52, 56.

Almost half of those extra services workers went into health care. If we want health care, that is what we want—but one of the inevitable consequences is a lower growth of productivity. The essence of the problem can be seen in the 300,000 security guards added to our economy since 1972. Since security guards protect old goods and do not produce new goods they add nothing to output, but they increase man-hours of work. The same number of passengers are flying from Boston to Los Angeles, but now it takes more hours of work to get them there since their luggage must be checked. The net result is a decline in productivity even though our sense of well-being may be up.

The remaining 30 percent of the decline can be traced to particular problems in three industries—mining, construction, and utilities. Mining and construction have even experienced negative productivity growth. Output per man-hour is less now than it was a decade ago. Utility productivity growth is down sharply.

The decline in productivity growth in electrical, gas, and sanitary utilities is the easiest to explain. This is a clear case where productivity growth is highly dependent upon the growth of output. Additional output is produced in new efficient plants, and a very large fraction of the labor force is overhead labor needed to maintain the distribution systems. When more energy is consumed, output goes up very rapidly relative to employment. Conversely when output stabilizes or goes down, productivity stabilizes or goes down. With the much higher prices of energy, output growth has slowed and some years even fallen, with a sharp fall in productivity growth from over 6 percent per year to 1 percent per year. The obvious cure is a return to rapidly growing consumption, but this is not likely given what is expected to happen to energy prices.

Mining productivity has fallen 23 percent since 1971. This is the one place where it is possible to lay part of the blame at the door on new health, safety, and environmental regulations imposed by government. But much of the problem is due to geology. Less oil is being produced from many more wells, and this shows up as a decline in productivity.

This is not to say that the regulations are either unwise or unwarranted. Greater health, safety, and environmental protection simply imposes large costs in mining. If we want safe mines and a clean environment, we are going to have a slower growth of productivity in mining, at least for a while, than if we do not want those things.

Construction is another industry with negative productivity—down 19 percent since 1968. Here the problem is partly a measurement problem and partly a real problem. How do you measure output in an industry that does not produce a standardized product? The standard technique is to use inputs (the volume of construction materials) to measure output, and this may underestimate real output if progress is being made in using materials more efficiently. We may also be demanding more variety in our construction—fewer large housing projects, fewer massive road projects—than in the past. And as a result, the construction industry does not get to take advantage of its learning curve or economies of scale.

As the decline in productivity is examined more closely, simplicity disappears. Even when the causes are clear, the solution is not. We have elected to fight inflation with idle capacity, and this explains 30 percent of our productivity decline. If agriculture were still disgorging massive amounts of labor, our productivity would be higher, but that phase of our industrial life is now over. Productivity would be higher if we did not want so many services, but the demand for services is only a problem if we were in some sense buying more services than we really want. One can argue, for example, that medical insurance leads us to buy more health care than we would buy if insurance were not available and every bill had to be paid in cash. But who wants to go without health insurance? Our real standard of living would grow more rapidly if we happened to want goods made in high-productivity industries, but we don't. To buy a high-productivity good that you do not want is not to raise your real standard of living, although it would accelerate the growth of productivity.

Productivity growth would be higher if energy prices were falling and consumption rising, if it were easy to make mines safe and environmentally sound, and if we all wanted to live in identical homes, work in identical factories, and shop in identical stores. But none of these things is possible. Simply raising investment might lower productivity growth since it would allocate more resources to an industry with below-average productivity—construction.

Just as the causes of our productivity slowdown are complex and varied, so will be the cures. In light of the fact that productivity has been growing at about 3 percent per year for as long as we have been measuring productivity growth (well back into the nineteenth century), and that our neighbors have achieved growth rates double or triple this in the last few decades, it is very unlikely that there will be a simple cure. Current productivity growth rates are deeply embedded in the structure of our economy, and major changes will be necessary before we see major improvements.

PRODUCTIVITY AND INTERNATIONAL COMPETITION

While advance in productivity in any sector contributes to our overall standard of living, our international competitiveness is primarily dependent upon what happens to productivity in two industries—agriculture and manufacturing. In this we differ from most other industrial powers in that over 20 percent of our exports are agricultural commodities. While we lag in manufacturing, in agriculture we continue to lead the productivity race with more than a 6 percent annual gain.

In agriculture the problem is not productivity but opening foreign markets to our producers. Agriculture is the industry that everyone, including ourselves, protects the most. For all practical purposes, the United States is a residual supplier to the rest of the world. Each country buys only what it cannot produce itself. Operating behind high price supports. Common Market farmers produce whatever they can. If crops are bad, the Common Market is a massive agricultural importer. If crops are normal, the Common Market is a large importer. If crops are very good, the Common Market subsidizes exports. Other countries do the same. This leaves us subject to large demand shocks and sudden price changes, but it also deprives us of one of our major export markets. As a consequence, we become more dependent upon our relatively weak sector—manufacturing.

To survive in today's international competition we must push for freer trade in agricultural products. It is our area of greatest comparative advantage. But it is also an area that illustrates our basic problem. While we have a large comparative advantage in the production of most agricultural commodities, we are not in a position to push for free trade since we protect weak agricultural areas (sugar, cheese, and processed meats) as much, or more, than the rest of the world protects its farmers. We need free trade in agricultural commodities if our economy is to compete, but we cannot demand it because we do not practice it. Overall, farmers would make large income gains, but particular farmers in some regions of the United States would lose. Here again, we cannot play an economic game with a substantial zero-sum element.

To keep pace economically we are going to have to give up our own protection in some areas and demand access for our products in other areas. We no longer can afford to accept a world where our agricultural commodities are excluded. Basically this is going to mean getting tough with our allies. West Germany and the rest of the Common Market have got to stop preaching free trade in manufacturing while practicing protection in agriculture. If Japan wants to export cars it has to be willing to import food.

Very limited progress was made in the recent Tokyo round of trade negotiations, but it was so limited as to not even constitute the first step in a very long march. Future trade negotiations must make progress on agricultural commodities. If necessary, we should begin limiting others' manufacturing access to our markets if they do not give us agricultural access to their markets.

In manufacturing there is no evidence of a slowdown in productivity once a correction is made for idle capacity, but this is the area where our productivity growth rates are the poorest relative to the rest of the world. Often these problems are blamed on American multinational corporations. As is true in most cases, the worries are greatest when the problems have passed their peak. In the past, United States multinationals undoubtedly moved production abroad faster than would have happened if they could not have owned those foreign facilities. But this activity is clearly on the decline.

Multinationals need low wages, stable governments, and educated labor forces to establish facilities that can compete with those in the United States. In Europe low wages are already gone. And they are rapidly disappearing in those parts of Asia (Korea, Taiwan, Hong Kong, Singapore) that have stable governments and an educated labor force. There are, of course, many countries with low wages that will be attractive for low-productivity industries, but these are precisely the activities where we should be disinvesting. If anything, foreign multinationals should contribute to manufacturing productivity in the future. Since wages are lower there, they are now starting to enter the United States. In the past we had little to gain, but now a company like Michelin brings us knowledge about producing radial tires that we do not seem to possess. When foreign multinationals enter the United States they speed up the transmission of industrial knowledge from high-productivity areas abroad to low-productivity areas in the United States.

ACCELERATING PRODUCTIVITY

Outside of agriculture, our basic problem is accelerating the growth of productivity. Our research and development expenditures may be too small (the right proportion of GNP to devote to R&D is one of those imponderables), but the real problem is a substantial bias toward developing new products rather than new processes for producing old products. This bias exists for two reasons.

First, new products are always more glamorous than new processes for producing old products. Scientists and engineers would rather have government R&D money go into new products. Second and more importantly, we have great difficulty in publicly funding process R&D in an economy where production is almost always in the private sector. When government funds are used to finance the development of new products in universities, no one can predict the chief economic beneficiary if success is achieved. Government officials cannot be accused of deliberately raising the income of some particular firm. In process R&D, however, the potential gainer is clearly identifiable—the firms that now make the product in question. In the case of defense or space we are willing to provide public R&D funds for process improvements since governments is the ultimate buyer of the products that will be most efficiently produced. But when it comes to civilian production, we are reluctant to provide public funds for process R&D, since the question arises as to why the taxpayer should have to contribute to make some stockholder richer. To engage in process R&D, tax money must be taken from one private individual and given to another. But this is what we cannot do.

Yet as we have seen, the heart of the productivity problem lies in quickly advancing down the learning curve. Process R&D expenditures are needed to generate a steep learning curve, but the learning curve lies in the private sector. One could argue that the private sector should finance its own learning curves, but there are good reasons why R&D is financed by government both here and abroad.

R&D expenditures are financed by government for the simple reason that no private firm can hope to appropriate all of the benefits that might occur. A new product may be developed, but it may not be of use to the firm financing the work. The firm does not have the expertise or complementary products necessary to take advantage of the breakthrough. If the product is developed with public funds, the research lies in the public domain, and the firms that can use the product can gain access to the knowledge necessary to exploit it. Governments pay for R&D since what may be a good investment for the whole society may be so risky for any one firm that it will not undertake the expenditure.

The same inability to appropriate all of the benefits exists with process R&D. Suppose a new product has been developed—solar cells that directly transform sunlight into electricity for our existing space satellites. Given current volumes and production techniques, they are too expensive for earthly electricity generation. You are a manufacturer thinking about civilian production. You know that large process R&D expenditures and large initial investments would be necessary to go into production. If the learning curve is very steep your investment will be profitable, but a shallow learning curve could exist which would make your investment unprofitable.

If you were certain that you and only you could reap the benefits of success, you might take the risk, but you know that this is very unlikely. If you succeed and the learning curve is very steep, you may get your product to market first, but other firms now know that success is possible. They can start production knowing that a steep learning curve exists. Eventually they will find the path you found and gain some of the benefits you were counting on.

In essence the problem is similar to that of a book on chess end games. If you are told that the game can be won in four moves, it is almost always possible to find the four moves, but in a real game not knowing that victory is within your grasp you do not look hard enough and never find the four moves. The first person down the learning curve paves the way for the followers. He demonstrates that success is possible. But not being able to get all of the benefits, no one may be willing to be first. And even if someone is willing to be first, we have an inefficient process where different firms must essentially reinvent the wheel—the desired process.

To speed up productivity we must find an acceptable technique for involving government in process R&D. There are probably three essential ingredients. First, we all have to accept the fact that any government program is going to help someone. The fact that the winners can be identified ahead of time does not make a program wrong. As long as we have a private profit system of enterprise any public efforts to raise productivity will make more profits for someone. Second, there is nothing wrong with profits and making someone rich if we have a fair system of taxation. Tax reform, and having what is perceived as a fair system, is an important ingredient in stimulating productivity since it allows us politically to shift R&D to areas where it can have a large productivity payoff. Third, process innovations paid for with government funds should be available to everyone in an industry. Other firms should be able to study how it was done at the first firm so they can get the same productivity gains without having to make duplicating R&D expenditures.

This is essentially what we now do in agricultural R&D where new processes are tried out on experimental farms and then offered to all farmers. In this case the experimental farms are owned by government, but this is not possible in most industrial operations where production units may be very large. But however, we do it, we must restructure the economy so that we can engage in more process R&D and gain more of the potential benefits of steep learning curves. New products are important, but at any point in time most of the economy is composed of old products. Making these products more efficiently is the heart of the productivity problem.

While foreign analogies should be treated with caution, it is instructive to think about Japan's success with process innovations. They have not been a leader in new products, but they have been a leader in better processes for producing old products. This springs from the absence of a sharp dividing line between public and private, and a willingness to engage in process R&D. But to do this the Japanese must take revenue away from some Japanese and give it to other Japanese. We are reluctant to do this when it comes to private corporations because we cannot justify a transfer of resources from one American to another.[7]

Accelerating disinvestment is the second ingredient in speeding productivity growth. Ending subsidies, protection, and favorable regulations will help, but we are not going to be able to do so until we find a way to provide economic security for individuals without providing economic security for failing institutions. At the same time we also need to go beyond a free market policy that promotes disinvestment and encourages reinvestment in high-productivity areas.

We do not need central economic planning in the sense of an agency that tries to make all economic decisions, but we do need the national equivalent of a corporate investment committee to redirect investment flows from our "sunset" industries to our "sunrise" industries. Such committees play an important role in the investment decisions of large corporations and they could play an equally important role in national investment and disinvestment decisions.

With our current system of internal finance, growth in high-productivity areas is often limited by the funds that can be internally generated. This often lowers their growth and our national growth below what it should be. Similarly with internal financing, "sunset" industries often have access to plentiful funds for new investment. They can reinvest their internal savings, but their steady cash flows also let them borrow in the capital markets. Often these investments should not occur. A national investment committee could help make sure they did not occur.

For most of our industrial competitors the central bank plays an important role in allocating investment funds. In addition to worrying about the money supply and the rate of interest, it attempts to direct funds toward areas of major national interest. The system is probably most heavily developed in Japan but exists to some extent in Italy, France, and West Germany. In the past our Reconstruction Finance Corporation played a similar role. It could and did provide major funding for large projects in new areas.

A national investment bank could be regarded as a competitor with private banks or it could work through private banks as it does in Japan. It certainly represents more government in the mixed economy, but the time has come to recognize that if we are going to compete with some of our more successful industrial neighbors, we are going to have to change the way we have been doing things in the past. Simply retreating into the past and calling for the end of government involvement won't solve the problems. We have to do much better than we have ever done pre- or post-New Deal if we are to compete in the productivity race of the 1980s.

While there is much to be gained by taking our foot off the current economic brakes on economic change, we must also learn to put our foot on the economic accelerator. If others have learned how to more quickly reorientate their economy to new growth areas, so must we. We do not have to reinvent the wheel, we merely have to adopt and adapt what others have learned to our culture and institutions.

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[7] Thurow. *The Zero-Sum Society.* See Chapter 8.

While a decline in investments did not cause our current productivity problems, an increase in investment is probably one of the ingredients in a cure. Those who are doing better than we invest a substantially larger fraction of their GNP. But to invest more, we have to do two things. We have to create incentives to increase investment, and we have to accumulate the necessary funds for this investment.

The simplest part of the problem is increasing the incentives to invest. The easiest solutions would be to abolish the corporate income tax and integrate corporate and personal taxation. With full integration, there would be no corporate income tax but each individual shareholder would be liable to pay personal taxes on all income (retained or paid out) earned on his or her behalf. At the end of the year, shareholders would get the equivalent of a W-2 form telling them how much income to add to their other sources of income and how much income tax had been withheld on their behalf.

Since corporate after-tax rates of return would approximately double, corporate managers would have a strong incentive to increase investments. At the same time, we would increase both the equity and progressivity of the personal income tax. Each shareholder, rich or poor, would now pay taxes at a rate commensurate with his own income position rather than at some common rate. Taxes would go down for some, up for others.

The corporate income tax should be abolished regardless of whether you are a conservative or a liberal. Based on our principles of taxation, the corporate income tax is both unfair and inefficient. In a country with a progressive personal income tax, every taxpayer with the same income should pay the same tax (horizontal equity), and the effective tax rate should rise in accordance with whatever degree of progressivity has been established by the political process (vertical equity). The corporate income tax violates both of these canons of equity. Consider the earnings that are retained in the corporation on behalf of the individual stockholder. Low-income shareholders with personal tax rates below the corporate rate of 46 percent are being taxed too much on their share of corporate income. To the low-income shareholder the corporate income tax is unjustly high. Conversely, high-income shareholders with personal tax rates above 46 percent are being taxed too little on their share of corporate income. To the high-income shareholder the corporate income tax is a tax shelter or tax loophole. As a consequence, vertical equity is being violated. Horizontal equity is also being violated, since two individuals with exactly the same income will pay different taxes, depending upon the extent to which their income comes from corporate sources.

It is important to notice, however, that to eliminate the horizontal and vertical inequity of the corporate income tax, the tax must be eliminated on both dividends and retained earnings. Simply eliminating the corporate income tax on dividends increases the tax shelter aspect of the tax without achieving equity.

While corporations are legal entities that write checks to government, they do not pay taxes. They simply collect money from someone—their shareholders, their customers, or their employees—and transfer it to government. There is no such thing as taxing corporations as opposed to individuals. This immediately raises the issue of who ultimately pays the corporate income tax. The incidence of the corporate income tax is an area of economics with a large literature and little or no argument. Depending upon the exact assumptions used, the definition of incidence, and the time periods under consideration, it could be a tax on shareholders, a sales tax on consumers, or a tax on employees. (Personally, I believe that it is a tax on shareholders in the short run and a sales tax in the long run, but my advocacy of its elimination does not hang on that belief.) While there may be certain perverse political virtue in collecting a tax where no one is sure whether he pays it, simple economic efficiency and equity would seem to call for the elimination of taxes where incidence is uncertain. Only if we do so can we establish a tax system that is fair and has the economic consequences we intend.

Since interest payments are deductible business expenses while dividends are not, the corporate income tax also biases the structure of capital toward debt capital and away from equity capital. Debt capital becomes cheaper than equity capital, not because that is true in the market, but because the tax laws make it so. From the point of view of the efficient allocation of capital and an efficient capital structure, there is no reason why government should be intervening to bias business choices in the direction of debt capital and away from equity capital. From the point of view of having a healthy, vital capitalistic economy, government should, if anything, be doing the opposite. Eliminating the corporate income tax would eliminate this bias in capital structure and hence improve the efficiency of the capital market.

But the capital market would also be improved in another way. Since the maximum personal tax rate (70 percent) on property income is substantially above the corporate income tax rate (46 percent), and most corporate shares are held by high-income individuals, there is a strong incentive for firms to retain earnings, reinvest them, and provide benefits to their high-income shareholders in the form of a larger capital stock and higher stock prices. As long as the stock is held, no personal income tax will be paid, and when it is sold, only the lower capital gains tax need be paid. While there is nothing wrong with retained earnings, it once again should be up to the market rather than the tax laws to determine how much income should be retained rather than paid out to the shareholders. Eliminating the corporate income tax would remove the tax incentive to retain earnings. As a result, both the supply and demand for funds in the capital market would increase, once again leading to greater efficiency.

To the extent that the corporate income tax is in fact a sales tax collected from the buyers of corporate products, a number of benefits would accrue from its elimination. The prices of corporate products would gradually fall with favorable effects on the rate of inflation. Because of lower prices, our competitiveness in international markets would also increase, and this would be especially true vis-a-vis countries that can rebate their value-added taxes on exports. The net result would be more goods sold and more Americans employed.

If all of these advantages exist, why do we have the corporate income tax, and why is it still defended? Many people, including the man on the street, think that it is a way to tax the rich. As I have shown, this is simply a mistaken perception. To the extent that the corporate income tax is a sales tax or a tax on employees, it is not a tax on the rich. Even if it is ultimately paid by the shareholder, it is not a very good tax on the rich. To tax the moderately rich we must tax the poor at very high rates and provide a tax shelter to the very rich. If we want to tax the rich, the personal income tax is the right way to do it.

Some liberals oppose the elimination of the corporate income tax on the grounds that low-income stockholders would not have enough cash income to pay the taxes owed on the earnings retained on their behalf. This is not a problem, since corporations could be required to withhold taxes for shareholders just as they now do for employees. Every year shareholders would receive the equivalent of a W-2 form that would list their corporate earnings and the taxes that had been withheld on their behalf. Those overwithheld would receive a refund, and those underwithheld would have to pay the additional taxes owed just as they now do on their wage and salary earnings.

Some business managers support the corporate income tax on the grounds that it encourages retained earnings, and it gives them more funds not subject to the competitive bidding of other managers in the capital market. To some extent this perception is undoubtedly true, but I suspect that shareholders would still be willing to tolerate some substantial amount of retained earnings in a system where the tax system was neutral with respect to whether earnings were or were not paid out.

Those who manage government often oppose the taxation of corporate income as personal income on the pragmatic grounds that less revenue would be collected and thus some other tax would have to be raised. Depending on exactly which estimate of the distribution of stock ownership by income class is used, Treasury losses range from $4 to $10 billion or from 2 to 5 percent of the revenue now collected from personal and corporate income taxes. To put this amount in perspective, simple elimination of the corporate income tax on dividends would cost the Treasury $13 billion. The revenue shortfall arises not so much because individual shareholders would pay less than they now do (some would pay more, some would pay less, and the balance depends upon the distribution of stock ownership by income class), but because a substantial amount of stock is owned by institutions (charities, pension funds, and so forth) that do not pay personal income taxes.

In the long run much of this shortfall would be recouped, and that which is not recouped would yield substantial benefits. To the extent that pension funds have higher incomes, they are either going to reduce contributions (leading to higher taxable incomes) or increase the pensions paid (leading to higher taxable incomes). If nonprofit charities have higher incomes, the public will, to some extent, give less to charities (leading to higher taxable incomes). To the extent that the higher earnings of charities are not offset by lower annual giving, they will be doing more good works. And this is, after all, why we made them tax exempt in the first place. If we really want to tax them, we can easily pass a law doing so in any case. At the moment we are simply being inconsistent and taxing their corporate, but not other, sources of income.

When you review the arguments, there isn't any case for the retention of the corporate income tax. It is both unfair and inefficient. It ought to be eliminated. And all corporate incomes—retained or paid out as dividends—ought to be taxed at personal income tax rates appropriate to the shareholders who own them. In doing so we will increase the fairness of the tax system, improve the allocation of investment funds, and create a powerful incentive for more investment.

Increasing the incentives to invest is relatively simple, but raising the necessary funds for investment is difficult—not economically but politically. We are confronted with the question that I posed to the Harvard alumni reunion. If we were to raise investment from 10 percent of the GNP to the 15 percent level of West Germany or to the 20 percent level of Japan, who would be willing to give up 5 or 10 percent of the GNP? Conservatives say that we should generate the extra savings by lowering taxes on savers and raising taxes on consumers. Basically this means shifting the tax burden from rich to poor since savings propensities are naturally much higher for the rich than for the poor.

There is no doubt that the extra savings could be raised in such a manner if the shift in the distribution of income were sharp enough. Suppose that households with incomes below $16,000 per year (the bottom 60 percent of the population in 1977) saved nothing, and that households with incomes above $38,000 (the top 5 percent of the population) saved 50 percent of their extra income.[8] To raise savings by 5 percent of the GNP you would have to transfer $188 billion from the bottom 60 percent of the population to the top 5 percent of the population. This would lower the real standard of living of the bottom 60 percent of the population by 25 percent. The income of the top 5 percent would rise by 46 percent. (In fact the transfers would probably have to be larger than this since the bottom 60 percent do some saving and the top 5 percent may not have a 50 percent marginal savings rate.) To accomplish the necessary objective—more savings—a majority of the population would have to endure a sharp reduction in their current consumption. Not surprisingly they are reluctant to do so. Yet more savings are necessary if more investments are to be made.

The direct way to solve the problem in an equitable manner is simply to run a surplus in the government budget of the appropriate magnitude. Taxes are raised by the necessary amount, and each of our incomes is reduced in accordance with a tax system. If we have an equitable tax system we have an equitable spreading of the burdens. But this directly poses the question of what is an equitable tax system and an equitable distribution of after-tax income.

More investment, speedier disinvestment, more process R&D—they all pose the fundamental zero-sum distributional question. Someone's income will have to go down and these losses are going to be substantial. For those that lose, the existence of even larger social gains are irrelevant. They are only interested in preventing their losses.

ECONOMIC GROWTH AND MARKET PROCESSES

(By Richard H. Fink)

I. INTRODUCTION

The aim of this essay is to provide an alternative view of economic growth in a market economy through what is known as a market-process perspective—so called because of its emphasis on disequilibrium, uncertainty, evolutionary change, and the paramount importance of the subjective perceptions of market participants. Since all economic phenomena are the result of the actions of individuals, the market-process economist traces the intended and unintended consequences of individual interaction in alternative institutional settings. Since success of any one individual's plans depends upon the actions of other market participants, the coordination of plans among economic actors is critically important for successful economic growth. The market-process economist views the market as an evolving institution that primarily serves to generate the information and the incentives to facilitate this necessary plan coordination. Market signals such as prices, profits, and interest rates are important coordinating phenomena that have spontaneously evolved in the market system. Since uncertainty and imperfect information pervade the world, these sensitive signals provide vital information to market participants and greatly facilitate the plan coordination of producers and consumers, complementary and competing firms, and the intertemporal activities of all economic actors. Given this view of the market as an institution that not only disseminates critical market-coordinating information, but also generates this information, the market-process economist is especially concerned with economic policies that unintentionally distort these market signals and therefore interfere with plan coordination.

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[8] U.S. Bureau of the Census, *Current Population Reports, Consumer Income 1977,* Series P-60, no. 117 (December 1978), p. 19.

Only with a coherent theory of economic growth can one understand the causes of the significant productivity problems facing America and not be misled by the scores of plausible but ultimately erroneous explanations of prosperity and stagnation. Section II, Economic Growth—A Market-Process Perspective, offers the rudiments of such a theory. Since this essay is intended to explain an alternative view of economic growth and not to explore the fine points of theory, the model is intentionally simplistic and therefore passes over many of the rich theoretical refinements and controversies surrounding some of its assumptions. Section II endeavors to establish the connection between individual decision making and economic growth, as well as the need to think beyond the concepts of aggregate savings and investment. Instead, I suggest focusing analysis on the way in which individuals' plans to save and invest must interlock with the plans of other economic actors to be successful. The functions of prices, profits, and interest rates in the overall process of market coordination are given special attention.

Section III, The Effects of Government Policies on Economic Growth, builds on the basic model presented in Section II and demonstrates how recent economic policies have disrupted the conditions necessary for sustained economic growth. These policies have not only reduced the level of savings and investment but have consistently frustrated market coordination. The key point in this section is not only that government policies reduce the available resources for investment activities, but that these policies unintentionally distort the market signals necessary for individuals to successfully carry out plans in the face of the uncertainties and complexities of an industrialized economy. One example, monetary disruptions of the coordinating function of the interest rate, is developed in some depth. Although any of a number of possible examples would serve to illustrate the importance of plan coordination in successful economic performance, the example of the interest rate was chosen because most economists, including supply-side advocates, either completely ignore or explicitly dispute this particular coordination problem.

Section IV. Keynesian, Neoclassical, Supply/Side and Market/process Approaches, explains why the conventional Keynesian and neoclassical tools are ill-equipped to deal with some of the critical problems connected with economic growth in a dynamic economy. By contrast, a market-process framework readily enables one to see that a key to understanding many of our present day economic problems lies in the examination of economic policies affecting market coordination within and across industrial sectors, rather than just focusing on the aggregate size of these sectors. Coordination problems are lost in the level of aggregation employed in Keynesian macromodels and they are assumed away in neoclassical growth models. Supply-side economists in general ignore coordination problems for both of these reasons, Section IV also explains how supply-siders confuse the coordinating functions of various market signals when they analyze the impact of government policies.

Part V, Policy Recommendations, welcomes the attention on tax cuts by supply-side economists and the Reagan administration, but not without serious reservations. While taxes are a significant factor affecting economic growth, they are neither the only factor nor necessarily the most important factor. Concerns about productivity must address the significant consequences of policies other than taxes that affect economic growth. The most important challenge to supply side economists will be to address the problems of market coordination which are almost totally ignored in the current literature. Reindustrialization, industrial welfare, and varied depreciation schedule changes advocated by some supplysiders have significant implications for market coordination which are presently ignored and can result in severe disruptions to sustained economic growth. These disruptions can be readily appreciated in a market-process framework that examines the market mechanisms that tend to coordinate intrasector as well as intersector economic activity.

II. ECONOMIC GROWTH—A MARKET-PROCESS PERSPECTIVE

The amount of attention currently being given to taxation, productivity, and economic growth is largely due to the inability of the American economy to maintain a satisfactory track record. As a result we have seen many competing explanations of our economy's woes and even more recommendations of how to alleviate these problems. This section of my analysis will attempt to present a market-process theory of productivity and economic growth, which will provide the reader with at least one foil with which to evaluate current economic policies.

No final and all-encompassing definition of economic growth exists among economists. Economic growth has been associated with a number of different phenomena including technological progress, "lengthening" of the structure of production, and an increasing stock of capital. I prefer to view the quest for economic growth as simply an attempt to raise future living standards relative to present living standards.[1]

As a science, economics has nothing to say about the *desirability* of economic growth. As along as scarcity exists, men must choose between competing ends, and a choice of one of these ends implies the sacrifice of other ends. Like any end, economic growth has its opportunity costs, for it must compete with other goals such as more present consumption or more leisure. The advocate of an increase in economic growth rates is implicitly making the claim that future benefits from growth outweigh the current sacrifices necessary to achieve this growth. Which end is most important is a value judgment and such judgments are outside the realm of the value-free science of economics. However, what an economist can do is contrast the consequences of, and possibilities for, economic growth in various institutional settings.

One such institutional setting is an unhampered market economy. This proves to be an especially fruitful setting for examining productivity and economic growth because by initially factoring out existing government policies we can obtain a clearer picture of the cumulative consequences of these policies. We can then examine previous government policies which helped determine our present productivity as well as the proposed policy measures intended to improve our situation.

A variety of factors are relevant for determining how much an economy will grow and what sort of growth will be achieved. The most important of these factors are time preference (savings-consumption decisions), the ability of the price system to allocate resources to their most highly valued uses, intertemporal coordination of plans, and the degree to which new investment projects are successfully integrated into the existing capital structure.

To illustrate these points, assume that on one of your frequent trips to the French Riviera your plane crashed into the ocean and because of your superior swimming skills you become the sole survivor on a deserted island. After waking up from a deep sleep that allowed your body to recover from the trials of the crash and your struggle to reach the shore, you find that you have to search eight hours a day for food just to survive. Assume that you prefer fish (as opposed to coconuts or other culinary delights that the island has to offer)—so you fish eight hours a day and engage in leisure (rest) the remainder of the day. You soon become unhappy with your present standard of living and want to increase it in the future. Therefore, you decide to fish twelve hours a day and after two days you have accumulated enough fish to sustain you for a third day without fishing. Now you are facing at least two choices: one of consumption, e.g., sunbathing the third day, or investing—building a net to increase your future production possibilities. By saving or accumulatinig fish for two days and abstaining from the present consumption of leisure, i.e., sunbathing, you have been able, through the construction of the net, to realize economic growth, i.e., have raised your future living standards. Now you can catch your daily subsistence of fish in four hours instead of eight. Your act of savings allowed you to engage in economic growth. The foregoing of present consumption allowed you to produce a capital good (the net) and to develop a longer and more productive structure of production. This has traditionally been called "lengthening the structure of production" and is illustrated below by the additional step in the production process.

$$\text{Man} \xrightarrow{1} \text{fish} \xrightarrow{2} \text{consumption.}$$

$$\text{Man} \xrightarrow{1} \text{net} \xrightarrow{2} \text{fish} \xrightarrow{3} \text{consumption.}$$

(capital good)

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[1] Therefore, an individual's "economic growth" decision involves the attempt to create a future circumstance where he or she will be able to command more scarce resources in the future than he or she would otherwise be able to do.

In this primitive society savings directly determined the level of investment, for the number of fish you caught directly determined how many days you could devote to investment (building the net). This direct relationship between savings and investment is altered in a complex monetary economy, as the existence of money creates an "intercession" between savings and investment. Acts of saving and investment will usually be performed by different groups of individuals (or individuals acting in different roles) who will most likely have different purposes. Such complexity poses serious problems involving the coordination of all these various plans—a problem of economic coordination that all economic systems must solve.

In a complex industrial society such as the United States, the price system is a critical mechanism for discovering and disseminating information about the thousands of economic resources and almost limitless possible combinations of these resources. Prices are the reflection of the value that millions of individual actors within the economy place on specific economic goods. Information on consumer's valuation is of necessity scattered, vague, and incomplete. Market prices synthesize this value information and convert it to a usable form. Buyers, by bidding for goods, are attempting to establish the case that particular goods are most urgently demanded and most valuable to them because they are willing to bid the highest in order to purchase them. Suppliers, guided by the bids of demanders, are alerted to where scarce resources should be channeled to reach their most useful employment. This familiar tale of the interaction of suppliers and demanders illustrates the critical coordinating function of prices in allocating scarce resources to their most highly valued uses. Since prices are the direct result of bidding by economic actors, expressing the value of resources in their plans, and because they convey the most accurate and timely information, then external interference with market-generated prices will cause people to act on distorted information. And, an individual's economic plans based on distorted information disrupts not only his activities but the plans of others because of the extensive interdependence of economic activity in a complex economy.

Profits, on the other hand, provide the incentive for effectively utilizing the information disseminated by prices. In addition to rewarding successful entrepreneurial behavior and penalizing entrepreneurial errors, profits act to redirect the command of scarce resources away from entrepreneurs who either are inept at reading price signals or have acted on incorrect information (and thus suffer losses) toward entrepreneurs with a demonstrated record of success (i.e., profit makers). Profits put money—and therefore the command of scarce resources—in the hands of entrepreneurs who have demonstrated good judgment. Thus, profits and losses play at least two key roles in a market economy; they provide incentives to produce the goods that consumers must urgently want and direct resources into the hands of those most competent in bringing the goods to market.

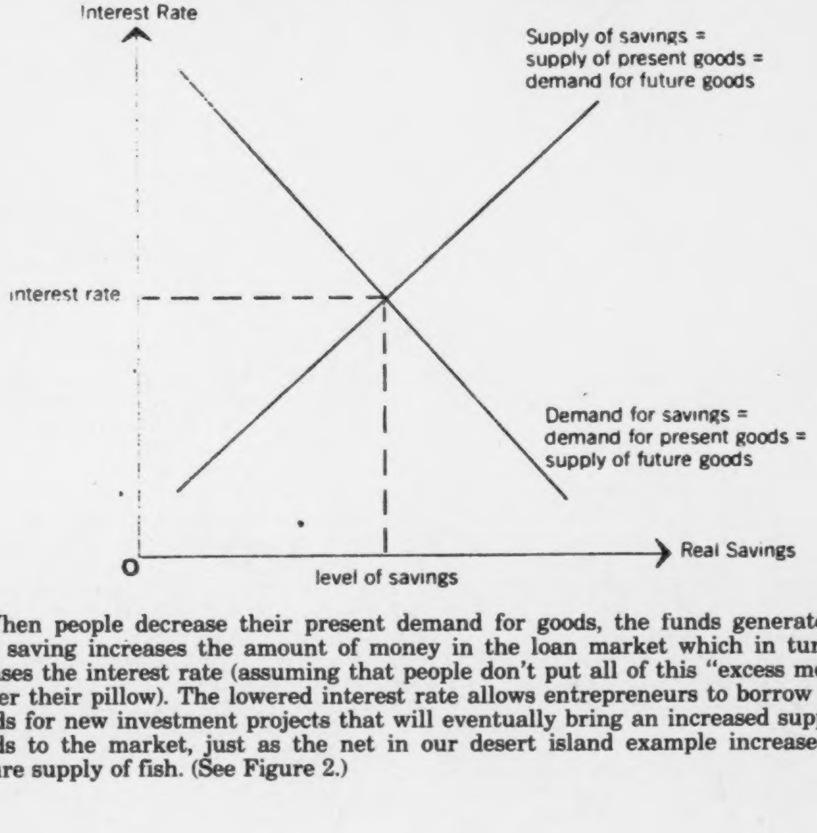
The interest rate is another important market signal. It aids in redirecting resources *across time,* by reflecting individuals' preference for economic growth as well as their commitment to make the necessary sacrifice of present consumption to realize this growth. Interest rates are, therefore, a critical information-generating signal for allocating savings and investment and hence the prospects for realized economic growth. To the extent that the rate of interest tends toward its market clearing level, it will serve to coordinate *ex ante* the plans of savers and investors by disseminating information about the terms on which economic opportunities will be offered.

The very act of saving on the part of an individual implies that his demand for present consumer goods has gone down and that his demand for future consumer goods had increased. After all, few people save indefinitely for no reason—most people save to provide for enhanced future consumption in a few years, for their old age, or for their heirs. How much an individual saves depends on his time preference in conjunction with the constraints he faces in the market. Time preference is the subjective evaluation of future command in relation to present command over scarce resources. The decision to save $100 today in order to be able to purchase $110 worth of goods next year indicates a time preference reflected by the 10 percent return. You prefer $110 a year from today over spending the $100 today. If you prefer the $100 today you would have a higher time preference—something higher than $110, perhaps $120, would be required to induce you to save the $100 today for the opportunity to spend it a year from now.

As can be seen from this example, time preference is merely the trade-off we all have between present goods and future goods. We save todays in the expectation of being able to exercise an increased ability to demand goods in the future (future goods). This is what the demand for economic growth is: the preference for a rise in future living standards at the expense of present living standards (consumption). To realize this increased preference for growth requires increased saving—the present sacrifice for future gain.

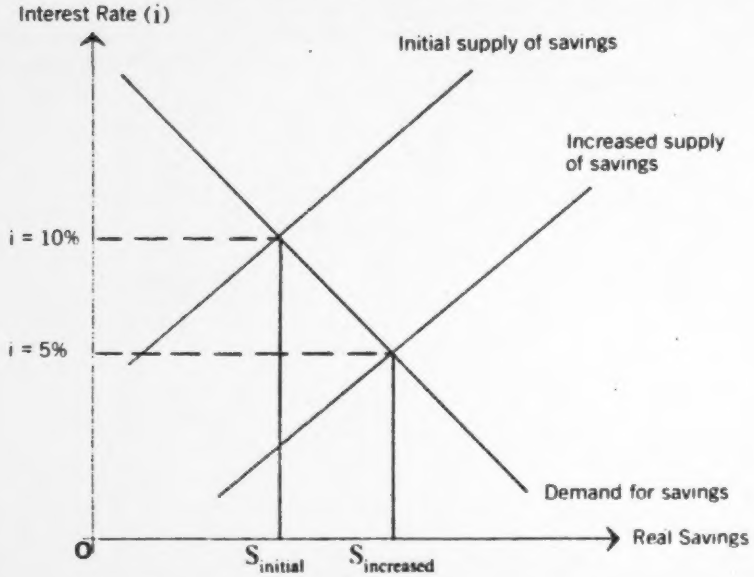
How does the market respond to this decline in present demand for consumption goods and the increase in future demand that results from the decision to increase savings? It responds in the same way that is does whenever the relative demand between any other two goods changes—it provides the incentive and the information for entrepreneurs to decrease the supply of present goods to match the decreased demand and to increase the supply of future goods to match the increased future demand. (See Figure 1.)

FIGURE 1
INTEREST RATE DETERMINATION


Interest Rate
Supply of savings = supply of present goods = demand for future goods
interest rate
Demand for savings = demand for present goods = supply of future goods
O
level of savings
Real Savings

When people decrease their present demand for goods, the funds generated by this saving increases the amount of money in the loan market which in turn decreases the interest rate (assuming that people don't put all of this "excess money" under their pillow). The lowered interest rate allows entrepreneurs to borrow these funds for new investment projects that will eventually bring an increased supply of goods to the market, just as the net in our desert island example increased the future supply of fish. (See Figure 2.)

FIGURE 2
DECREASE IN TIME PREFERENCE



The previous discussion should help clarify the importance of prices, profits, and the interest rate for the intertemporal plan coordination of economic actors in any discussion of economic growth. Intertemporal plan coordination is necessary for savings to be converted into the most highly valued investments, and the price mechanism is the primary means through which this process is accomplished.

Perhaps the least understood feature of economic growth is the necessity of creating new capital goods which will perform a complementary function with other capital goods. The importance of this particular sort of coordination is often forgotten in neoclassical models which treat capital as a homogenous aggregate rather than as a complex heterogeneous structure. Yet different sorts of new investments should not be treated as equivalents because each investment will effectively "interlock" with the existing capital structure in a different way and to a different degree. An example of this point is given by Western aid to underdeveloped nations. While agencies such as the World Bank may advance the capital which allows the lesser developed countries to purchase such technologically advanced ventures as steel mills, hydro-electric plants, and mechanized agriculture, these projects are rarely integrated into the structure of production of the underdeveloped nation. More often than not, these countries will have little or no support industry to produce spare parts, to train the necessary high-skilled labor, or even to use the products of the new industry. The amount of capital will have increased in the lesser developed countries if we view capital as a homogeneous aggregate. Therefore the addition of the steel mill to the capital stock will appear as equally valuable as any other investment of comparable magnitude. But if one views capital as a heterogeneous structure, the steel mill is a misallocation because it is not integrated into the existing capital structure.

The extent to which an economy manages to coordinate its capital structure is due primarily to the degree to which its key market signals—prices, profits, and interest rates—are not impeded in performing their coordinating functions.

III. THE EFFECT OF GOVERNMENT ECONOMIC POLICIES ON ECONOMIC GROWTH

When the problems of economic growth and the effects of macroeconomic policy are examined within a microeconomic market-process framework, the implications are that government policies critically lower the level of savings as well as distort market activities that affect virtually every economic decision made in the economy: interest rates, the incentive to invest (profits), the relative profitability of investing in particular economic sectors (opportunity costs), and the coordination both of plans among entrepreneurs and with the consumption plans of consumers (prices). These implications are not adequately addressed in either aggregate demand models or aggregate supply models.

A. Savings

Using a market-process framework, some interesting questions arise concerning the level of savings and the low rate of economic growth in the United States during the past twenty years. What factors affected individuals' proclivity to save—to finance economic growth? One important factor is the income taxes people have to pay on the money they earn from productive activity. Much of what remains after their income tax is paid is used to purchase present consumption goods on which, more often than not, one must pay a sales tax. If a person owns property, he pays additional property taxes. If you wish to provide for your family when you die, you pay inheritance taxes. If an individual wants to provide for other people while they are living, they pay gift taxes. Whatever is left to save and generate interest income is also taxed. When all taxes, visible and hidden, are taken into account, nearly half of a person's income can go to taxes. After that, a major part of the remaining half will probably not be available for savings. No doubt the largest portion of the remaining income will usually be spent to provide subsistence in the present—housing, food, clothing, etc.—leaving very little for savings.

In addition to the burden imposed by taxes, the American consumer is able to extract far fewer products out of his remaining income because there are fewer goods available and the prices they command are higher as a result of thousands of government regulations and edicts. Controls raising prices, such as minimum wage laws, interest rate regulations, milk price supports, natural gas price regulations, rent controls, and subsidies ranging from Chrysler to tobacco growers to beekeepers all result in a drain on the consumer's pocketbook.

Exacerbating the strain on savers and further distorting the production structure is inflation, which has destroyed traditional avenues of saying and therefore pushed people to search for alternative places to sink their money needed to provide for the future. Precious metals, jewelry, and art objects have been favorite sinkholes. Regulations on the maximum interest rates that financial institutions can offer have also tended to discourage saving and rechannel savings into alternative institutions. Inflation has helped cause a dollar invested in tax avoidance and/or tax evasion bring a much larger return than a dollar devoted to saving as evidenced by the tremendous growth in the number of accountants and the underground economy. Lastly, what saving *is* encouraged is usually channeled into consumer durables, such as housing, because of tax laws, inflation, and subsidies. Any thorough treatment of economic growth since World War II needs to investigate these phenomena.

B. Production

The problem is twofold. The first difficulty is that government economic policies substantially diminish the stock of goods available for future consumption. However, even more significant than the effect on total output is how government policies influence the structure of production, once the crimped pool of saving is invested. Prices that normally direct resources into those channels of industry that satisfy the most urgent demands of consumers are artificially altered. Marginal producers exit the industry and nonspecific factors of production are shifted into other industries. Specific factors may lie idle instead of being utilized to produce the goods that consumers most readily demand. Resources shift out of overregulated and price-controlled sectors into less urgent uses, such as subsidized industries. Effort and expenditure, normally devoted to production, is diverted into avoiding the wealth losses from unfavorable regulations and clamoring for subsidies and favorable regulation. All of these distortions have serious consequences both for the quantity of savings and for the uses to which these savings are put. A more thorough study than is warranted here would examine further distortions to productivity caused by labor laws, tariffs, licensing laws, etc., which alter relative prices and therefore distort resource allocation devoted to the provision of such services as medical, legal, plumbing, electrical, carpentry and imported as well as domestically produced goods.

Government policy also affects economic growth through its impact on investment decisions made by the producers of the actual capital equipment, such as the steel mills, and the research and development necessary to supply the goods that will help generate a rising standard of living. A brief run-through of several pertinent facts is revealing. The corporate sector of the United States has been taxed at a nominal rate between 40 and 50 percent. However, after taking inflation into account, the real tax burden is sometimes over 100 percent. The impact of such a high rate of taxation on the profitability of investment is staggering. According to Martin Feldstein of Harvard University and the National Bureau of Economic Research, the average rate of return on investment is around 4 percent.[2] A 4 percent return on capital invested is generally not an adequate incentive for the risks and efforts of many entrepreneurs. Other reasons for this low return on capital invested include the hidden tax of regulation that has been estimated by various economists to cost from $20 billion to $200 billion a year.

Another factor harmful to economic growth is the tremendous consumption of our national resources by government itself, a process which drives up the prices of the remaining resources and distorts the relative prices of all resources. Government absorption of resources that would ordinarily go to fuel economic growth is nowhere so evident as in American land and labor markets. "The U.S. land area is 2,271,343,000 acres. The federal government owns, manages or controls slightly over one-third, approximately 760,532,000 acres. Most of the public domain is located in the West, with about 63 percent of all the land in the thirteen western states owned by the federal government. Additional holdings by state and local governments bring the total government land ownership of the U.S. to about 40 percent."[3] Not only does government control of land raise the price of various land parcels but it also distorts the prices of privately owned land, strategic minerals, and various other natural resources. In terms of the supply of labor available for building a foundation of growth, employment of one out of every five workers is directly related to government. And an even greater number is indirectly diverted from production because of government-mandated paperwork studies, impact reports, etc. These two primary factors of production, land and labor, therefore require a greater expenditure to be utilized in many production processes that might occur in an economy with a smaller government sector. The market signals determining their allocation have been significantly altered by government policies.

Government bail-outs and subsidies to inefficient firms are another factor that not only wastes valuable resources but also impinges on the normal incentive structure of the unhampered market. Major industries such as automobiles, television, and steel are now clamoring for protection from foreign competition in order to lessen the market forces of competition that weed out inefficient producers. Corporate America, like the individual citizen, finds that it is extremely profitable to devote scarce resources not to produce but to discover ways to reduce their tax and regulatory burden. Firms find that a dollar spent lobbying in Washington for special favors brings a greater return than a dollar spent in production. Rather than outcompete a rival, it is cheaper to lobby for selective regulations to drive him out of business.

Unemployment insurance, minimum wages, immigration laws, affirmative action quotas, welfare, CETA, and government intrusions into the labor market tremendously raise certain costs of production as well as redirect resources away from their most highly valued uses. Union activity, normally part of the market mechanism, has been distorted by government interference which allows unions to prevent lower income people from bidding jobs away from higher paid workers in industries with union-induced wage scales. Strikes and the threat of strikes can cause a tremendous amount of resources, normally devoted to enhanced production to be diverted to stockpiling inventories in order to allow a firm to survive a strike. These factors all affect economic growth and should be incorporated into any analysis.

Inflation is another factor that has received a tremendous amount of attention, but it has not been fully integrated into the microeconomics of economic growth. Most analyses of inflation ignore the fact that relative prices are distorted as new money is pumped into the economy. These distortions occur because the new money created by the government enters the economy in specific ways and therefore raises specific prices in a certain pattern. As these artificially induced prices continue to rise, entrepreneurs respond as they do to all relative price changes—they redirect resources into the newly (seemingly) profitable areas. But this flow is exposed as a malinvestment when the government stops pumping new money into the economy (or more often, slows the rate of increase). So there is good reason to suspect that the boom induced by government policies affecting the money supply is causally related to recessions (where the malinvestments are revealed). The economist studying economic growth must address these business cycles where vast amounts of resources are wasted because, for some reason, *most* entrepreneurs in whole sectors of the economy are in error (when in normal times only some entrepreneurs make critical errors). Why do these highly skilled professionals systematically err at one particular point in time and generate a recession? The creation of false price signals generated by government-induced monetary expansion provides some interesting clues.

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[2] Martin Feldstein, "Inflation, Taxes, and the Rate of Savings" (Lecture delivered at a conference on "Inflation: The Consequences for the Economy," sponsored by the Institute of Humane Studies and the Austrian Economics Program. Rutgers University, Newark, N.J., April 28–29, 1979).

[3] Robert J. Smith, "Preserving the Earth—The Property Rights Approach," *Policy Report* 4 (Washington, D.C.: Cato Institute, February 1982): 1.

While many analysts recognize the income redistribution effects of inflation, most are either unaware of or deny the serious redistribution of *resources* caused by inflation. The most important example of this redistribution of resources can be seen operating through the "time market." The critical link between economic growth, the quantity of savings, and the interest rate was explained earlier. We saw that when individuals lower their time preference (decreasing their present consumption and increasing their savings), they are effectively exercising an increased demand for economic growth. Suppliers react to these future demands when the increased saving lowers the interest rate and therefore makes investment less costly than before because interest outlay is a significant aspect in the investment decision. Not only are most investment projects stimulated, but they are stimulated to different degrees. The relative profitability of longer-run projects increases relative to shorter projects. A short example will illustrate the point:

Assume that you are faced with two investment projects that have the same net present value after you take into consideration outlays, expected income, and subjective preferences.

* Where N = number of years project lasts, i = the interest rate, and R = net anticipated revenues generated by the investment project.

$$NPV_1 = \frac{R_N}{(1+i)} = \frac{1100}{1.1} = \$1.000$$

where $N = 1$ year
$i = .10$
$R = \$1100$

$$NPV_2 = \frac{R}{N} = \frac{100}{.10} = \$1.000$$

where $N = \infty$
$i = .10$
$R = \$100$

Investment project 1 returns $1,100 in income in one year and no revenue thereafter. Assuming the interest rate to be 10 percent, the net present value of this project is $1,000.

Investment project 2 returns $100 in revenue every year in perpetuity. Assuming that the interest rate is 10 percent, the net present value of this investment project is $1,000. Assuming that you have incorporated all your subjective preferences into the outlay and revenue figures, you should be indifferent between these two projects.

Let's suppose that the interest rate declines to 5 percent because of the increases in the supply of savings (see Figure 2). The net present values of these two projects will increase but to different degrees.

$$PV1 = \frac{R}{(1+i)} = \frac{1100}{1+.05} = \$1.050 \Rightarrow \uparrow 5\%$$

$$PV2 = \frac{R}{i} = \frac{100}{.05} = \$2.000 \Rightarrow \uparrow 100\%$$

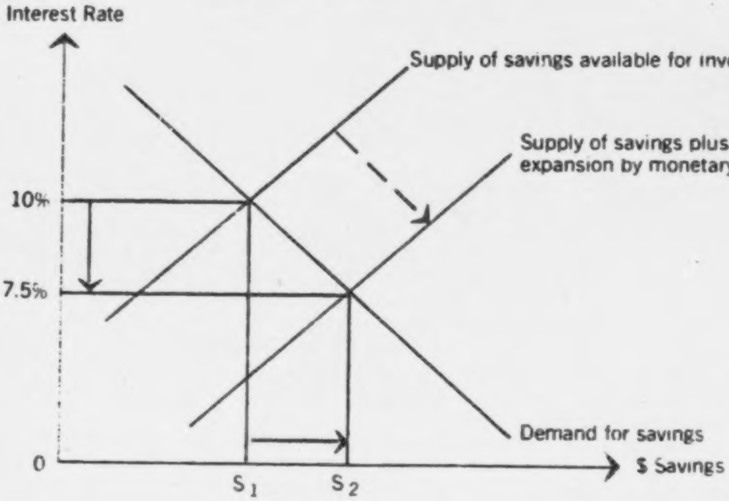
While the net present value of investment project 1 will increase 5 percent, the net present value of investment project 2 will increase 100 percent, making the longer-run project a much more attractive investment.

This example illustrates the crucial signaling role played by interest rates. Just as distorted prices cause a misallocation of resources in various markets, distorted interest rates cause a misallocation of resources over time. Past monetary policies have affected interest rates in a systematic fashion and therefore have had systematic effects in the capital goods markets. As government pumps money into the economy through the commerical banking system, the banks find that they have more money to lend out. In order to lend out this increased quantity of money, they lower the interest rate—generating an increased quantity demanded of funds and, as shown above, altering the relative attractiveness of various investment projects, by making longer run projects relatively more profitable. To the extent that entrepreneurs base their plans on the lower interest rate, they are responding as if consumers demanded more economic growth when in fact they do not. In this way monetary policy generates false signals inducing entrepreneurs to supply an increased quantity of future goods to consumers who have not expressed this preference. If the government doesn't continue pumping money into the economy at an increasing rate, firms will find themselves short of funds available to complete their investment projects. But in the meantime, capital resources are being misallocated on long-term business ventures throughout the economy.

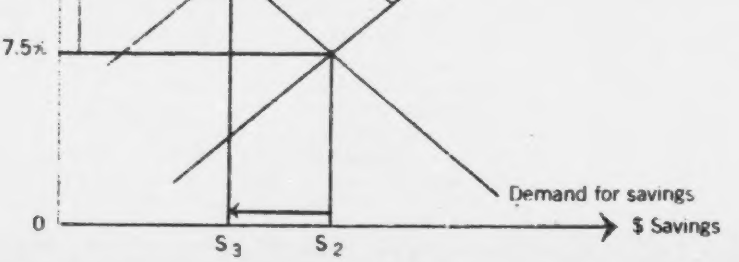
Neither have the consequences of credit expansion by a monetary authority been widely recognized. Nor have some of the secondary consequences of the monetary authorities' decision to slow down, stop, or actually decrease the money supply been fully appreciated by economic analysis.

A decrease in the money supply (or a decrease in the rate of increase of the money supply) will cause interest rates to rise. (See Figure 3.) The unexpected shortage of funds will lead people to scramble for money and credit in order to minimize the disruption of their ongoing plans. The shortage of money will send producers to the loanable funds markets to bid for the reduced supply of bank credit and this will result in higher interest rates. What has been surprising to many analysts during periods where the monetary authority reverses its expansionist policy is not the fact that interest rates rise but the degree to which they rise and the length of time they stay "high" before they approach "normal" levels.

FIGURE 3
INTEREST RATE LOWERED
BY CREDIT EXPANSION



INTEREST RATE RAISED BY CREDIT CONTRACTION



Inflationary expectations are often the catchall used to explain high interest rates during such periods, despite the fact that one would expect a decreasing rate of price inflation. However, there is another possible explanation that helps to explain the interest rate pattern associated with the retraction of an expansionist monetary policy.

An example is perhaps the simplest method of illustrating the point. Let us assume that a firm starts a long-term investment project that is expected to take ten years to complete. The project is thought to be profitable if the outlays, including financing costs, are constant or will increase at a moderate rate. Assume that the project is expected to generate $10 million in revenue when it is completed ten years later, and that the expected profitability is based on interest rates of around

7.5 percent (either that interest rates are currently 7.5 percent and will continue to be so or that they are lower and are expected to rise to a maximum of 7.5 percent). But five years later there is a significant decrease in the amount of bank credit available because of contractionist monetary policy. The firm had little reason to expect this dramatic turnaround in the availability of funding to finance the continuation of this project. This firm, and others in similar situations, will either abandon the project before completion or attempt to complete the project by bidding for the remaining available funds. If firms abandon ongoing projects they will lay off workers and decrease or stop orders for raw materials and capital goods used in the projects. Some firms may go bankrupt causing complementary firms that depended on these firms to suffer. Unemployment of all types of resources will result from the primary and secondary consequences generated by the revelations of these malinvestments.

Firms which successfully receive a portion of the existing credit will have paid a much higher rate of interest. Suppose that our firm is able to acquire the existing funds to complete the investment project, but it must pay an interest rate of 15 percent. The 15 percent interest rate is much higher than what was originally considered to be a profitable range (which was any rate up to 7.5 percent). Will the firm abandon the project or continue to completion? One important factor in determining the profitability of completion is how much of the project remains to be done and how much is already done. If the firm abandons the project, it will not realize any of the anticipated $10 million in revenue. All it can hope to recoup is either scrap value or resale value of its resources which is often far below the expenditures that were necessary to produce the goods.

Assume that one-half of the project is completed. The completed portion of the project represents a sunk cost (net of resale and scrap value which we assume is zero for the sake of simplicity). Now it is quite possible that an interest rate of 15 or 20 percent is worth incurring given that half of the project is a sunk cost and therefore no longer enters the decision. The question that this firm and others with ongoing projects face is given the substantial wealth loss they have incurred because of the jump in the interest rate, given the fact they would never have started the project if they could undo their decision, will the $10 million of revenue warrant paying a 15 percent interest rate for the next five years? Even though the project represents a substantial loss from the perspective of the start of the project, it may still be worth completing. Bygone costs are of course bygone; all that needs to be determined is whether or not the additional costs required to complete the project, including 15 percent financing costs, are less than the expected $10 million in revenue.

Ceteris paribus, the closer the project is to completion, the lower the interest elasticity of the demand for funds. The further the project is from completion, the higher the interest elasticity of demand for funds. The demand for credit depends not so much on the demand to finance new investment projects, which represent only a small portion of investment activity, but on the credit needed to finance the completion of existing projects that were started at various points in the past. Only new investment projects will immediately be abandoned because of the much higher elasticity of demand for credit in these projects.[4]

The example presented above assumes away many complications as any example must, but the introduction of such complications as the effect of interest rates on replacement costs, of inflationary expectations raising the costs of completing the project, and of the degree of specificity in the component parts of the project, would alter the numbers and the empirical applications, yet the basic point would not change. Moreover anything which leads entrepreneurs to expect that there will be more funds available and therefore a lower interest rate than actually occurs will eventually generate higher interest rates.

During the period of unusually high interest in 1981, some economic analysts argued that investment activity was healthy despite the fact that the interest rate had risen to over 20 percent. One of the reasons given in support of this view was that producers were borrowing at such high rates and that therefore they must feel that the investment projects will generate a greater than 20 percent return. Thus, profitable investment activity had not dried up, and entrepreneurs must be very optimistic because of their strong demand for funds. Of course, what is true in this argument is that only people who anticipate that the benefits outweigh the opportunity costs will borrow funds at 20 percent. One doubts, however, whether the borrower of funds at a 20 percent interest rate, who expected to be able to borrow funds at 10 percent and has lost millions of dollars because of the higher interest rates, will view the investment climate as healthy. Surely he will prefer to borrow than not, given his desperate straits—but with such a notion of health one can only wonder what ill-health would be like.

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[4] F. A. Hayek. "Investment that Raises the Demand for Capital," in idem. *Profits, Interests, and Investment* (Clifton, N.J.: Augustus M. Kelley, 1975), pp. 74–76.

The real question that must be examined is why there have been so many errors in anticipating the profitability of investment projects and the level of interest rates. Why, during the normal course of affairs, do we see some people making errors, but most making correct decisions with little disruption to economic growth? Why, at other times, do we observe that the majority of entrepreneurs are induced into making poor investment decisions?

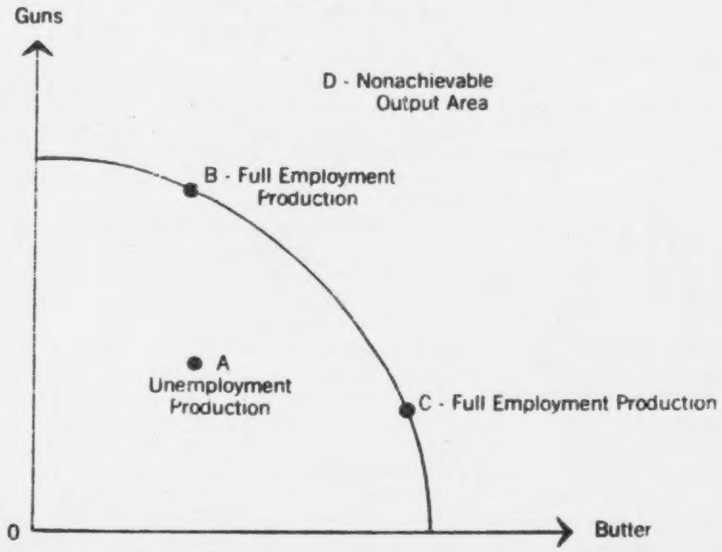
The success of entrepreneurs is almost wholly dependent on their ability to deal with the uncertainty of the future. The signals that entrepreneurs rely upon (prices and interest rates, et al.) are geared to capture information about future events. An explanation of business cycles must examine the reasons why these entrepreneurial tools fail at certain periods of time. One candidate involves the methods used to administer monetary policy. Expansionary monetary policy that increases the availability of funds for investment through open-market operations initially lowers the interest rate below what it would have otherwise been. The expansionist monetary policy causes price inflation, which after a time induces the monetary authorities to reverse the policy. Because the monetary authorities have a history of trying to affect peoples' expectations by pronouncements, one can rarely base his plans on what the monetary authorities say they will do. But the reversal of the inflationary policies is inevitable—usually before the inflation causes the destruction of so much of the industrial structure, as in Germany in the early 1920s. After having induced lower interest rates by increasing the money supply, the monetary authorities induce higher interest rates by reversing this policy.

The major point being stressed here is that at least one key market signal for allocating resources over time—the interest rate—is distorted by government monetary policy and therefore generates serious coordination problems. Changing incentives by altering tax policy will not remove these distortions to the capital structure any more than it will address the problems of distortions to market prices caused by regulatory policies. Stimulating the aggregate or macroeconomic levels of savings and investment will not solve the uncoordination generated by monetary policy which channels these funds into malinvestments.

IV. KEYNESIAN, NEOCLASSICAL, SUPPLY-SIDE, AND MARKET-PROCESS APPROACHES

An interesting way to illustrate some of the critical differences among Keynesian, neoclassical, supply-side, and market-process views of economic growth is provided by an analytical tool called "the production possibilities frontier," which portrays the locus of all technologically efficient, full-employment opportunities that the economy can reach. (See Figure 4.) Areas to the right of the curve represent nonachievable output because the technical apparatus of the country is not sufficient to produce such high levels of output even when the economy is fully coordinated and operating at "full capacity." Areas within the curve denote production possibilities that are associated with higher than technically efficient unemployment levels—unemployment of all factors of production including land, capital goods, and labor. Although, in reality, one would want to consider all goods and the nearly infinite number of possible combinations among these goods, for expository purposes we will let the graph demonstrate the production of only two goods. This simple graph examines the traditional split among neoclassical, Keynesian, supply-side, and the market-process approaches.

FIGURE 4



Standard neoclassical microeconomic theory adopts assumptions and models that are basically concerned with the desirability of point B relative to point C from the perspective of the consumer. If one adopts the neoclassical view of the world and follows its basic assumptions, one will reach the conclusion that the economy will always tend to a full employment situation and that the economy will automatically jump from point B to C or from point C to B as consumers desire. The Keynesian challenge to neoclassical economics addressed points such as A where it appeared that the economy had stagnated at a state of high levels of unemployment and showed little tendency to move to a full employment situation, such as B or C, as neoclassical economics would lead one to believe. Economists were essentially left with two contrary theories to explain one world. One postulated an automatic market mechanism able to bring the economy to full employment, and the other postulated a market mechanism more likely to stagnate at intolerable levels of unemployment.

In an attempt to reconcile these two theories. Paul Samuelson developed what has been called the "neoclassical synthesis," which essentially maintained that aggregate demand policies were necessary to push the economy toward the production possibility frontier—but once the economy reached any point on the frontier the neoclassical notion of market adjustment took over and shifted resources to areas where consumers most readily demanded them. The idea was that government is needed to assure that the economy hovered around the production possibilities frontier. If the economy deviated significantly from the frontier, unemployment, low national product, and low national income generated negative expectations which rippled through the economy (i.e., the multiplier) and resulted in an inadequate level of aggregate demand. However, once government monetary and fiscal policies assured a reasonable level of aggregate demand then the market could perform reasonably well.[5]

Market-process economists point out that construing the jump from A (recession or a depression) to B or C (full employment) in terms of aggregates ignores a number of important considerations, for the economy is not a piece of clay easily molded by aggregate policies. Whether the economy moves along a path of A—B or A—C is critically important. Machinery, trained laborers, resource requirements, etc., geared to produce B cannot be switched to produce C without a disruption to the economy. If government monetary and fiscal policies distort prices, profits, and the interest rate and therefore push the economy toward B while voluntary exchange and consumer preference would have led to market signals that geared the economy toward C, then retooling of the economy from A to C will lead to significant economic problems. The boom caused by government policy employing resources in the direction of B will generate the bust or recession when the productive equipment, laborers, etc., are inevitably retooled to be coordinated with consumer preferences at point C. The reason the economy was in the range of point A to begin with is precisely because of past monetary and fiscal policies channeling resources into malinvestments that later had to be liquidated and retooled.

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[5] William H. Branson. *Macroeconomic Theory and Policy* (New York: Harper and Row, 1972), pp. 3-4.

The value of these insights is exemplified by the fact that market-process economists warned of the coming depression of the 1930s while the economy was booming in the 1920s. They were able to determine that market signals—prices, profits, and interest rates—were being distorted by government policy and that the scarce resources were being mischanneled and malinvestments were bing created because distorted prices and profits were misdirecting entrepreneurs into sending resources into the wrong sectors of the economy.

What is critical for economic growth in a market-process economists's view is not so much the overall level of activity in the economy, not merely how many resources are bing devoted to investment and consumption, nor some aggregate measure of productivity or percentage increase of GNP. Rather, it is whether or not the plans of entrepreneurs who are allocating particular new materials, capital goods, labor, and consumer goods are coordinated with the plans of other members of the economy. The problem of coordination, far from being minimized by current monetary and fiscal policy, has been greatly aggravated by it in the market-process view. Merely stimulating aggregate demand or aggregate supply doesn't address the real requirments for sustained economic growth. The critical aspects missed by Keynesian and neoclassical economists when dealing with growth are the need for coordinated economic activity, the effects of institutional changes on individual action, and the effects of government economic policies on market coordinating information generated by such market signals as prices, profits, and the constellation of interest rates.

Supply-side economists on the other hand confuse the roles played by different market signals. They especially misconstrue the nature of prices. For example, these economists have discussed the need to change the relative prices of consumption and savings and of leisure and work in order to encourage investment and enhance productivity.[6] However, no such "prices" exist because "consumption," "leisure," and the like are summary categories of particular types of behavior and not economic goods. Prices, as generated by the market, express the exchange value of specific goods and services—not general classifications of human activity. Prices are the result of a valuation process that attempts to capture the interplay between the utility that a good offers to consumers and the opportunity costs of the producers who supply the good. Prices aid market participants in making the benefit-opportunity cost comparisons that are necessary to channel resources into production of goods most urgently demanded by consumers.

Nor is the distinction between relative prices and profitability only a theoretical refinement. For if supply-siders feel that in addressing incentives, they are also addressing the coordination problems inherent in pricing, their policies will end up being woefully short-sighted. In their conceptual confusion, they run the risk of overlooking coordination problems altogether. If relative price information is distorted, then the most urgently demanded goods are not produced. Accurate price information helps ensure that the "right" things will be produced. Profitability, on the other hand, does not provide the information of what specific goods and services to produce. Rather it provides the incentive for producers to use price information effectively. The decision to produce and the choice of what to consume are made at different times. The producer or entrepreneur is always dueling with uncertainty as he tries to guess consumer demands, and prices are an important calculating tool. But distorted prices will tend to generate plans which result in market coordination problems, regardless of either incentives or profitability.

Thus supply-side economics does address the market role of incentives, but it has not addressed the informational problems associated with economic coordination. Supply-siders have correctly focused on the disincentives toward harder and longer work when marginal tax rates are high. However, even if supply-side tax policies are instituted and the level of savings and investment increases dramatically, the informational problems associated with distorted prices and interest rates that guide the channeling of this investment remain. For example, tax cuts do not address the problem of determining which specific capital goods should be bought, where should new plant and equipment be located, how capital-intensive should any given production process be, and how do these investment plans dovetail with the plans of other producers and with consumers. These problems can be solved only by removing the distorting influences on prices and other market signals. Despite their claims to the contrary, supply-siders are still dealing in the realm of macroeconomics in much the same way as aggregate demand theorists. By confusing relative profitability with relative prices, supply-side economics has missed the crucial issue of microeconomic coordination.

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[6] The confusion over the role of relative prices and relative profitability is evident in even the most prominent supply-side economists. For example, see Paul Craig Roberts, "The Breakdown of the Keynesian Model," *The Public Interest,* no. 52, (Summer 1978); and Norman Ture, "The Economic Effects of Tax Changes: A Neoclassical Analysis," in U.S. Congress, Joint Economic Committee, *Special Study on Economic Change 4, Stagflation: The Causes, Effects and Solutions* (December 17, 1980): 316.

Assuming away critical informational problems has a well-established tradition in economics. It is not widely known that Karl Marx had a keen awareness of the coordination problems that must be solved in a market economy. However, Marx ignored the key informational problems inherent in a centrally planned economy. [7] As soon as Marx discovered a possible market coordination problem, he immediately assumed that a centrally planned economy would have no such problems. Neoclassical economists, many of whom insightfully focused on the informational problems associated with resource allocation in a socialist or centrally planned economy, assumed away crucial information problems when they drew their isoquants and their indifference curves. The neoclassicial notions of perfect competition and monopoly are futher evidence of the lack of understanding of the market's function of generating, as well as disseminating information. Somehow, some way, all the critical information is assumed to be known. Consumer preferences and consumer demand, technical transformations and marginal cost curves are all obvious to everyone, and coordination is automatically achieved simply by following neoclassical optimality rules. Who would need a market if we had all of this information—all we would really need is a very large computer.

Now the supply-side economists assume away another set of informational problems. One can only guess at the reason that market coordination problems have not been addressed. One possible reason is the use of conventional neoclassical tools which assume that the information needed to solve coordination problems is readily available and therefore coordination is automatically achieved if neoclassical optimality rules are followed. In this view, the market economy becomes a giant "computer" (perfect or flawed depending upon the economist) that assures the efficient allocation of resources and maximizes output.

The market-process economist sees the market in a fundamentally different role. In his view, the value of the market lies in its institutional role for discovering and disseminating information, information that is not available in other institutional settings and that is then effectively distributed to economic agents who can utilize it to coordinate their plans with the plans of others.

An alternative explanation is that supply-side economists believe that an unhampered market tends to solve the problems of economic coordination. If this is true, then an unhampered market also effectively deals with the problems of incentives. While supply-side economists have recognized the distortions to the market-incentive system they have simply overlooked the fact that these same economic policies also distort market information. This puts supply-side economists in a somewhat ironic position. If they continue to focus exclusively on incentives, then the supply-side approach is inadequate. If they expand their theoretical and policy horizons to deal with problems of information and plan coordination, there will be little to distinguish supply-side from market-process economists who, for decades, have recognized and analyzed the incentive problems caused by taxation as well as the distortions of market information caused by monetary and regulatory policies.

V. POLICY RECOMMENDATIONS

If one were to accept the goal that government policy should be primarily concerned with increasing productivity and stimulating economic growth, then the market-process perspective would suggest that the government should systematically eliminate policies that distort market signals—particularly relative prices, profits, and the interest rates. One would first attempt to eliminate those policies that cause the most distortion. This is hardly an easy task, but certainly monetary policies would have to be considered as critical as the realigning of incentives through tax policy. Supply-side tax policies designed to alter incentives to increase the level of savings and investment are of questionable value if this encouragement results in the production of malinvestments. Supply-side tax policy must be accompanied by an equally important focus on coordination problems caused by other distorting economic policies in so far as the ultimate aim is economic growth.

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[7] David Lavoie, "Rivalry and Central Planning: A Reexamination of the Debate over Economic Calculation under Socialism" (Ph.D diss., New York University, 1981), pp. 165–169.

While it would be best to repeal first those policies that have the most distortive effects on the economy, if political reality dictates beginning with a program of marginal tax-rate cuts, critics of supply-side policies would be wrong to oppose such a move. But insofar as these critics are alerting supply-siders to unaddressed or under-emphasized problems associated with other government policies that may thwart supply-side goals, their advice is invaluable. Supply-siders must understand that the lack of incentives is only part of the productivity problem and that there must be a systematic effort to repeal distorting economic policies. The level of savings and investment is important, but problems of market coordination may be even more significant.

On the other hand, government interventions on the supply-side—"reindustrialization." new taxes on consumption instead of investment, business subsidies, and the like—would damage long-run prospects for economic growth in the same way that past demand-management policies did. Like the earlier policies, they would distort market signals and misallocate resources.

SAVINGS IS THE KEY TO SUPPLY-SIDE ECONOMICS: A PROPOSAL

(By Stanley Kaish)

The term supply-side economics has been broadened to cover so much ground that for a while it appeared that we were all supply-siders. A similar thing happened a generation ago when a new body of thought named after Lord Keynes acquired sufficient breadth to encourage Milton Friedman to write a Theory of the Consumption Function and Richard Nixon to declare himself also a Keynesian in 1971. Supply-side economics appeared to have reached that same happy state where all but the most iconoclastic become co-opted in name, if not entirely in fact.

Still, it was never quite right to label everyone who is concerned with increasing output a supply-sider. Even though Walter Heller came to insist that his 1962 tax and capital consumption programs were supply-oriented, they were still very different from the Jude Wanniski-Jack Kemp proposals. There are many ways to increase output: improve education, reduce regulation, raise aggregate demand, improve manpower mobility, etc. If the term supply-side economics referred only to the achievement of increased supply, all of these could be included. It doesn't, of course. Supply-side economics is as much concerned with process as outcome, and the process it is concerned with is the enhancement of people's incentives to work, invest, and trade as a result of being assessed lower taxes. Those who want to increase supply by means other than lower taxes, or who want to lower taxes for reasons other than increased output fall outside the narrow bounds of this criterion.

While the goal is to increase output through a tax cut, there is, of course, more. Supply-siders also contend that they will lower inflation rates as well. Since inflation is a condition where too many dollars are chasing too few goods, an increase in the supply of goods, they argue, will reduce the root cause of inflation. It is hard for anyone who has ever shifted a pair of curves on the blackboard of a microeconomics class to argue against this point. The difficulty arises among those who teach macroeconomics. They know that tax cutting doesn't only give an incentive to work. It also gives increased disposable personal income and a resultant rise in demand for consumer goods. During the 1960's the rationale for tax cutting at a time when federal deficits were high and demand was sluggish was that demand would be stimulated and this would put people back to work. Today we are asked to suspend disbelief and accept the proposition that cutting taxes at a time when deficits are high is good for us precisely because demand will not be stimulated. Instead the increased disposable income will go into saving and be available for investment.

I am reminded of the 1952 Terence Rattigan movie called *Breaking the Sound Barrier*. The plot hinged on efforts of a test pilot to fly a plane in a power dive at speeds exceeding the speed of sound. The difficulty was that each time the pilot pulled back on the stick to get the plane out of the dive the craft broke up and crashed. Finally, in a moment of desperation the plane's designer suggested that the pilot push forward on the stick instead. It worked like a charm. Contrary to all precedent, the plane rose smoothly out of the dive as a result of this unorthodox treatment and history was made. Those accustomed to the idea that the way to combat inflation is through a holding down of demand may well feel that the Kemp-Roth prescription is akin to pushing forward on the stick while the plane is breaking up.

WILL THE TAX CUT BE SAVED?

It all comes down to whether or not people will save the tax cut. If they do save it, a redistribution of income out of current consumption use and into investment is possible. If they don't, nothing will have happened from the supply-side point of view. Consumption will be shifted from government to households, but it will still represent spending that is intended to satisfy current desires rather than to provide for future wants. If the consumption is added on in addition to the government spending—rather than instead of it—the country will have a severe inflationary situation on its hands.

Supply-siders appeal both to logic and history to convince us that lowering taxes will increase savings. One approach is to argue that lower taxes increases the net return on investments. Hence the opportunity cost of current consumption rises relative to the future satisfactions that are possible if one only saved for a while at the higher rates. At the old maximum 70 percent tax rate on unearned, (that is, *interest* income) it is a good deal more rational for rich people to buy luxury goods than it is to save. The alternative to purchasing a $50,000 Rolls Royce is to save the $50,000 and invest it. Perhaps the investment will yield 10 percent, or $5,000, annually. In the top tax bracket an investor would get to keep only $1,500 of that after taxes. Thus, a rich man buts a Rolls Royce at an opportunity cost of $125 per month—less than the cost of renting a Pinto. To clinch the deal, we note that if the savings are invested, inflation will depreciate the value of both income and principal over time. On the other hand, it is highly likely that the Rolls will appreciate in value under these circumstances. Evens sums up the theoretical argument with the simple assertion that "a reduction in tax rates increases the incentive of individuals to save by raising the rate of return on assets held by individuals. This higher savings leads to lower interest rates and higher investment."[1]

To back up this assertion Paul Craig Roberts calls our attention to the increase in personal saving and investment that followed the 1964 tax cut in the U.S. Although advertised as a demand-side program, he points out that the actual result was a higher rate of saving and capital formation over the next three years. Roberts adds, "Keynesians sometimes claim that the investment boom resulted from the investiment tax credit, but the sharp rise in investment could not have taken place if consumers had not released resources from consumption by saving a larger share of their income."[2]

What are we to make of these logical and historical arguments? It seems safe to admit that they may be valid, but on the other hand, a strong possibility exists that they are not. The opportunity-cost argument depends on the substitution effect between saving and consumption. Raising the price of consumption through lower taxes will reduce it desirability. We should, however, include the income effect in our considerations as well. By lowering taxes we raise the level of net income that will occur with any given amount of savings, and this tends to encourage more consumption as well. Indeed, the Brookings Institution's Robert Z. Lawrence, after reviewing the pros and cons concludes. "Economic theory is agnostic on the relation between saving and interest rate. When the rate of return on saving rises there is a substitution effect and an income effect and the sum of these effects may be either positive or negative."[3]

If we turn to Paul Craig Robert's "evidence" taken from the 1964 experience, we find we are on equally ambiguous ground. Remember in order for the tax cut to be noninflationary it is necessary that the bulk of the increased disposable personal income accruing to individuals be saved. This is not the same thing as seeing savings occur over the next three years. Just because savings eventually rose, it doesn't follow that the tax cut was saved. Indeed, Keynesian theory posits a chain of events that sees saving rise as a result of the increase in income that occurs if the tax cut were consumed. The simple multiplier process would produce the income rise and a positive marginal propensity to save will yield up the saving.

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[1] Michael K. Evans. "The Bankruptcy of Keynesian Econometric Models." *Challenge* 22 (January-February 1980): 19.

[2] Paul Craig Roberts, "Reagan's Tax-Cut Program: The Evidence." *Wall Street Journal.* May 21, 1982, p. 24.

[3] Robert Z. Lawrence. "Comments," in Joseph A. Pechman, ed. *What Should Be Taxed: Income or Expenditures?* (Washington, D.C.: Brookings, 1980), p. 31.

When we look at the figures, the best we can say is that they are ambiguous on this matter. Certainly savings went up in the 1960s. Over the three years following the 1964 tax cut we can measure a $12 billion increase in personal saving. However consumption during the same period rose by $93 billion. It seems just as reasonable to claim from this evidence that personal saving rose because of the increase in income as it is to suggest that income rose because of the rise in saving.

Furthermore, the representation that the substantial increase in investment could only have occurred if there had been an equally substantial release of funds from personal saving must also be questioned. True, national income accounting requires that saving must equal investment. But personal saving comprises only about a quarter of the annual gross saving generated by the domestic economy. The balance comes from capital consumption allowance, retained earnings, and net government surplus. Most private investment is financed out of internal business savings which in the year following the tax cut rose $7.5 billion against an increase of less than $2 billion for personal saving. The investment tax-credit may very well be more responsible for higher investment in the 1960s than the cut in personal taxes.

Two additional considerations cast shadows over the likelihood that a 1981 tax cut will be saved. The first is the different impact that a cut in tax rates had on savings in the inflation-free 1960s as constrasted to the inflation-ridden 1980s. In 1964 a cut in nominal tax rates was also a cut in real rates. Since then we have become all too aware of the phenomenon of bracket creep. Inflation is continually pushing people into higher income brackets and due to our progressive tax system, into higher marginal rates. When a 10 percent reduction in tax rates is accompanied by a 10 percent increase in nominal income, it is not long before one is right back where he started from in the tax table. Under these circumstances it is hard to mount a compelling substitution-effect argument. So, even if we concede that a rise in savings occurred in 1964, conditions in 1981 may differ critically.

The second difficulty arises from the administration's insistence on a three-year tax cut. While there are sound political reasons for striking while the iron is hot, there is also a great deal of economic theory and evidence that shows that permanent changes in people's income tend primarily to affect their consumption, while temporary changes mostly affect their savings. For example, the 1968 temporary tax surcharge levied in the hope that consumer demand would be diminished, thereby facilitating the allocation of resources to the Vietnam war effort, failed entirely. Between April of 1968 when the tax became effective and April 1969 personal saving fell by $12 billion. Evidently people kept right on consuming and paid their added tax levy out of savings. A similar experience occurred in 1975 when a one-time tax rebate was passed in an effort to raise consumption and stimulate the economy. The record shows that the next year a $37 billion fall in personal tax revenue was matched by a $34 billion rise in personal saving. Here was an instance where the Carter administration was trying to induce consumption and instead raised saving.

It would seem that if any lesson is to be learned from these fiscal experiments it would be reaffirmation of the permanent income hypothesis: people plan their consumption in terms of their expected long-run personal income. Temporary changes are saved. The three-year advance tax cut is exactly the wrong way to go to gain an increase in saving. It allows long-run planning of the use of the new disposable income and the odds are that it will be used pretty much like the old—basically for consumption. If a supply-side event is to be induced by tax cutting, the tax cut should be one that engenders a sense of uncertainty in the minds of consumers and of centainty in the minds of businessmen. That is, personal tax cuts should ostensibly be temporary, but business tax cuts permanent.

AN OLD PROPOSAL

Since a favorable inflationary outcome of the tax reduction program depends so heavily on individuals saving rather than consuming their tax cuts, and since there is little historical and theoretical reason to be assured that they will, it is quite surprising that the program has found the wide support it has. Undoubtedly it is due to the absence of viable alternatives. Kemp-Roth advocates have successfully exploited the political truism that "you can't beat somebody with nobody." When challenged, supply-siders simply and effectively answer, "We've tried Keynesian programs for the past twenty years, and they have produced deficits, inflation, and unemployment. What else do you suggest?" So far, no credible alternative has been offered by the other side.

It was within this context that early in 1981 I proposed that a variation of Keynes's compulsory saving plan be adopted to accompany the Kemp-Roth tax bill.[4] Published in 1940, Keynes's book *How to Pay for the War* offered an anti-inflation program for Great Britain's financing of World War II.[5] He recognized that it would be impossible to fund the total cost of the war through taxation, and that it was highly inflationary to finance it through debt unless purchasing power of consumers was deflected. Keynes thus called for a temporary compulsory saving plan whereby each earner would be required to set aside part of his current income for later consumption. The funds would be invested by a private portfolio manager selected from an approved list. As in today's Keogh plans, dividends and interest would accure and the total would be returned to each individual at a time of the government's choosing. Keynes proposed returning the funds at the end of the war to boost an anticipated sag in the economy.

The proposal received near universal praise in the academic community at the time of its publication. Some flavor of this can be gathered from a review written by F.A. Hayek, no ardent Keynesian then or now. Hayek wrote, "The outstanding topic in financial circles in the past week has been the ingenious proposal we owe to the most fertile mind among living economists. This is not surprising for if the proposal were adopted, it would go far to solve one of the most difficult and pressing problems of the war and immediately affect the position of a great majority of the population."[6] What supply-sider wouldn't be pleased to receive such a glowing review from a traditional adversary?

I suggested that since the long-term supply benefits of tax reduction were ardently desired, but the short-run inflationary pressure that will follow such a cut held the potential for disaster, compulsory saving was an idea whose time had come. Linked to the Kemp-Roth tax cut, it would give both the incentive-minded supply-siders and the inflationwary Keynesians an opportunity for accommodation. Some portion of the tax refund would be diverted to a Keogh-like investment fund for professional management and these funds and their earnings would accumulate in an account that is owned but not possessed by the taxpayer. I departed from the Keynesian plan when it came to choosing a time to return the principal and accrued interest. Rather than use it as a countercyclical measure which requires that we be able to forecast recessions well enough to head them off, I suggested a form of universal pension. As with the Keogh and IRA accounts, the funds would be held until retirement, taking some of the financial pressure off our burdened Social Security program.

Since I made that proposal, two important events have taken place. (1) The Kemp-Roth tax cut has become a reality, at least to the extent of a 25 percent reduction spread over three years, and (2) a general awareness of problems in the Social Security system has been thrust on the public. This juxtaposition of events has created a unique political opportunity for Congress to do something really important from the supply-side point of view. In one stroke it can minimize the inflationary impact of the tax cut, eliminate the solvency question hanging over Social Security, and substantially encourage capital formation. It can do this by using part of the Kemp-Roth fiscal dividend to convert Social Security from a pay-as-you-go to a funded retirement system.

While the focus in this paper is on enhancement of capital formation. Social Security's bleak financial outlook is certainly a compelling reason for change in and of itself. When Congress established the system on a pay-as-you-go transfer basis instead of as an actuarially funded program back in the 1930s it launched a vessel that sooner or later had to end up on the rocks. In 1945 there were 50 workers to support every retiree and as recently as 1955 there were 8.3. Today, changing birth rates, earlier retirement—in large measure encouraged by Social Security regulations—and greater longevity have reduced the worker-to-retiree ratio to just over 3-to-1 with some pessimistic projections suggesting a decline to 1.15-to-1 by the year 2055.[7] Where in the past rising benefits could be paid by new groups joining the system, today the only substantial cohort still outside the system is the federal government's employees, and they steadfastly resist being coopted. In fact, several of those state and local governments whose employees have a choice have chosen to leave the system. A more sophisticated public is aware that the money it contributes today is not held in trust for it, but rather is going out as rapidly as it comes in. Young workers are increasingly skeptical about whether the promises being made to them today will be kept by a generation of workers still unborn.

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[4] Stanley Kaish. "Cutting Taxes Without Inflation." New York Times, February 6, 1981, p. A: 23.

[5] John Maynard Keynes, *How to Pay for the War* (London: MacMillan & Co., 1940).

[6] F.A. Hayek, "Review of *How to Pay for the War.*" *Ecomonic Journal* 50 (June 1940): 321.

[7] President's Commission on Pension Policy, *Toward a National Retirement Income Policy* (Washington, D.C., 1981), p. 23.

Both Congress and the administration have suggested steps to improve the fiscal situation including an increase of retirement age to sixty-eight, a reduction of benefits to those retiring at age sixty-two, and a change in cost-of-living indexing formulas. The substantial constituencies of those retired and about to retire made no bones about their rejection of these proposals. Considerable political peril awaits anyone who tampers with the benefits side of the Social Security equation. Yet during the next seventy years the President's Commission on Pension Plans has projected an average shortfall of between 1.52 and 6.17 percent in payroll tax rates depending on one's degrees of pessimism.[8] It appears that some kind of Social Security tax rise will be inevitable, and this is obviously contrary to the direction today's supply-siders want to go.

While these financial difficulties have focused our attention on the need to "do something" about Social Security, they are, as suggested earlier, only part of the story. Less appreciated than Social Security's financial problems—but in the long run more important—is the extent to which pay-as-you-go funding has reduced our national rate of saving and hence our national rate of capital formation. If we are really intent on reindustrialization and supply-side enhancement, we should take steps to change our Social Security from a transfer to a funded system regardless of financial exigency. Let us see why.

Most contemporary economic models incorporate some form of life-cycle hypothesis of consumer behavior. In essence this theory suggests that people apportion their income between consumption and savings in a manner designed to even out the level of consumption they can enjoy over their lives. This requires that they accumulate financial assets during the productive working years in order to provide for retirement. In calculating the assets they intend to use during the retirement years, people include savings accounts, stocks, pensions, property and, of course, Social Security. Recent estimates show that the annuity value of Social Security benefits to the American people is in excess of $5.5 trillion.[9] Controversial though the idea may be, it seems clear that without these benefits to rely on working people would save more for their retirement.

Of course, the Social Security drag on capital formation occurs because there is not actual asset to represent that annuity claim. Contributions made by today's workers go directly to retired people who (according to the life-cycle hypothesis) spend the money almost immediately. Social Security is a program for consumption, not saving. As far as individual behavior is concerned it makes relatively little difference if there is a fund or not. In fact, many citizens are probably unaware of the peculiar nature of this funding. Milton Friedman has made much of what he terms "Orwellian doublethink" by the Social Security Administration (SSA) in its dealing with the public, charging that SSA literature intentionally misleads the public on the nature of their contribution.[10] Because the individual until recently neither knew nor cared how his Social Security was financed, he behaved as if savings were in the bank waiting for him when in fact they weren't.

Martin Feldstein has been the most important force in pushing an awareness of the economic growth implications of this phenomenon.[11] He has estimated that the economy loses one dollar of personal savings for every two dollars of Social Security benefits. While controversy swirls around Feldstein's figures and the method he uses to estimate them, the basic thrust of his argument seems irresistible. Social Security is the single most important source of retirement income in the U.S. by far. Even if the saving loss is one dollar for every five dollars of Social Security, instead of two dollars as Feldstein asserts, we find a shortfall of $1 trillion in capital formation due to this. No supply-sider can be oblivious to magnitudes of this order.

A NEW PROPOSAL

Given the current set of circumstances: (1) a constituency ready to accept something called supply-side economics, (2) the recently enacted Kemp-Roth tax cut, (3) the need to increase national savings to reduce the inflationary impact of the tax cut, (4) the public's concern over the Social Security system's solvency, and (5) the adverse impact of pay-as-you-go Social Security on capital formation, the time is opportune for implementation of a Social Security Investment Fund.

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[8] Ibid., p. 24.

[9] "The Crisis in Social Security." *Newsweek* (June 1981), pp. 25–27.

[10] Wilbur J. Cohen, Jr. and Milton Friedman, *Social Security: Universal or Selective*? (Washington, D.C.: American Enterprise Institute, 1972).

[11] Martin Feldstein. "Social Security Hobbles Our Capital Formation," *Harvard Business Review* 57 (July 1979): 6–8.

Beginning in 1984, half of the personal income tax reduction scheduled to go back to individuals should instead be earmarked for a Social Security Investment Fund (SSIF).

The SSIF should be used as a complement to the existing payroll tax. The two sources combined will sustain the current level of scheduled benefits.

A network of private portfolio managers should be contracted to invest and manage the SSIF as fiduciaries. This will avoid socializing the investment decisions that must be made in managing this vast pool of wealth.

The payroll tax rate should be gradually reduced and eventually the tax eliminated as the assets of the SSIF build up.

The ability of a Social Security Investment Fund to reduce the amount of payments needed to provide a given level of benefits is impressive. The existing transfer payment financing should be considered as equivalent to compelling people to engage in interest-free lending to the government. The money enters a revolving door, and even though the contributor sacrifices the short-run use of his money, he or she doesn't get the customary interest income reward for doing so. Under the SSIF, he or she does, and every dollar the fund can accumulate in interest earnings is a dollar less that taxpayers must eventually contribute.

A look at the annuity tables must impress us anew with the power of compounding, one dollar per year contributed over a working life of forty-five years and invested at 5 percent compounds to $159.70. Under the present—no interest—transfer system, of course, one dollar paid in each year for forty-five years brings only $45 worth of Social Security benefits. The other side of this coin is to consider what type of retirement income each can provide. The accumulation of $159.70 can finance an expected life retirement of sixteen years at $14.50 per year. Without interest, one dollar per year buys an annual retirement income of $2.80. To provide a more realistic retirement benefit level of $600 per month, it would be necessary to contribute $500 per year for forty-five years if it is permitted to accumulate at 5 percent annual interest. Under today's transfer program, with 3.2 workers supporting each retiree, annual payments of $2,250 per worker are required to support one pensioner at $600 per month. As the ratio of workers to retirees falls this figure will grow prohibitively.

This transition from pay-as-you-go to funded Social Security would occur gradually. As each worker retires, the fund will provide part of the benefits that would otherwise have to be paid through payroll tax transfers. The immediate offset to payroll taxes would be slight for older workers soon to retire. However, by the time the youngest in today's work force are ready to call it quits, they will have accumulated enough to supplant virtually all of the payroll tax that others would be called upon to pay for them.

CONCLUSIONS

It is clear that the nation is embarked on an experiment called supply-side economics premised on increased savings, investment, and effort coming forth in response to reduced taxation. There is substantial risk to be found here. This paper suggests that both logic and history give us reason to doubt that savings will respond as hoped. A proposal is made to establish a Social Security Investment Fund that will work to reduce the inflationary risk inherent in the tax cut and at the same time address some of the vexing anomalies of our Social Security system—the drag on capital formation and the difficult solvency situation that is developing. If this measure is added to the revolutionary changes that have occurred in U.S. fiscal policy recently, chances will substantially improve for supply-side economics to affect a permanent cure to the ailment of stagflation without bringing on the iatrogenic side effects of worsened inflation.

It is interesting that the germ of the idea proposed here comes from Keynes, an economist blamed by the supply-siders for our currrent economic difficulties. Keynes would appreciate the irony of this, for he wrote in *The General Theory* . . . . "Practical men, who believe themselves to be quite exempt from any intellectual influences are usually the slaves of some defunct economist . . . some academic scribbler of a few years back."[12] Elsewhere, he observed, perhaps still more relevantly, "On the economic front we lack not material resources, but lucidity and courage."[13] Hopefully, it will turn out that we showed a rare combination of both in the 1980s.

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[12] John Maynard Keynes. *The General Theory of Employment, Interest, and Money* (London: MacMillian & Co., 1936), p. 383.

The Results, Implications and Unresolved Issues of an Empirically Based Study of the Cost to Companies of Financing Value-Added Tax Cash Flows Under Alternate VAT Law Forms

(By Robert P. Crum, Assistant Professor of Accounting, Pennsylvania State University)

BACKGROUND

Improving the U.S. revenue base involves considerations other than revenue generation. The way taxes are collected and refunded, as well as the total tax collected, are important considerations in evaluating the overall desirability of a tax or its effect on business decisions. Among potential revenue sources receiving recent and current attention is some kind of value-added tax (VAT).[1]

The cash flows involved in paying, collecting, and remitting the value-added tax are important considerations to both national policy makers and individual companies. The Comptroller General's 1981 report on value-added taxation recommended that studies of VAT costs should be conducted with special attention to collection and reporting rules.

Specifically, the Comptroller General's report notes that:

> The VAT generates large amounts of money from many taxpayers, requiring special attention to collection and reporting rules. . . . large windfall gains or uncompensated losses to taxpayers can result.

And that:

> Studies to identify where the VAT costs are apt to be excessive could perhaps suggest ways to write the law or regulations to minimize them. These studies would be worth doing before any law is enacted, since they could affect the way it is written. They could even affect the decision whether a VAT is desirable.[2]

One of these costs is the "cost of financing VAT cash flows." Smith, Webber and Cerf have formalized these concerns about VAT cash flows:

> * * * a VAT creates and inflow or outflow of cash depending on the elements of the tax policy and the characteristics of the company. Any VAT cash inflow enjoyed by a company should earn it interest or save it interest on money it would otherwise borrow. On the other hand, any VAT outflow suffered by a company should generally cost it interest.[3]

From a policy standpoint, this financing cost affects the desirability of adopting a VAT. Figure 1 illustrates where "cost of financing VAT cash flows" fits into the overall policy considerations of a VAT. Individual company concerns are with the cost of financing VAT cash flows and the resulting effect on relative competitiveness and operating profit.

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[13] Keynes, *How to Pay for the War.* p. 1.

[1] President's Task Force on Business Taxation, John H. Alexander, Chairman, "The Report of the Presidents Task Force on Business Taxation" (Washington, D.C.: U.S. Government Printing Office, September 1970), p. 61; U.S. Congress, House (1979) Tax Restructuring Act of 1979 [H.R. 5565], 96th Congress, 1st Session, (Oct. 22, 1979); U.S. House (1980) [H.R. 7015] 96th Congress, 2d Session (Apr. 2, 1980); Lawrence C. Philipps and Gary John Previts, "Tax Reform: What are the Issues," Journal of Accountancy (May 1983), pp. 64-74; Jeffrey H. Birnbaum and Paul Blustein, "Raising Revenue," Wall Street Journal (July 27, 1984), pp. 1,7.

[2] Comptroller General of the United States, "Report to the Congress of the United States: The Value-Added Tax—What Else Should We Know About It?" (U.S. General Accounting Office Document Handling and Information Service, Mar. 3, 1981), pp. V, 36-37.

[3] Dan Throop Smith, James B. Webber, and Carol M. Cerf, "What You Should Know About the Value Added Tax," (Homewood, IL: Dow Jones-Irwin, Inc., 1973), p. 152.

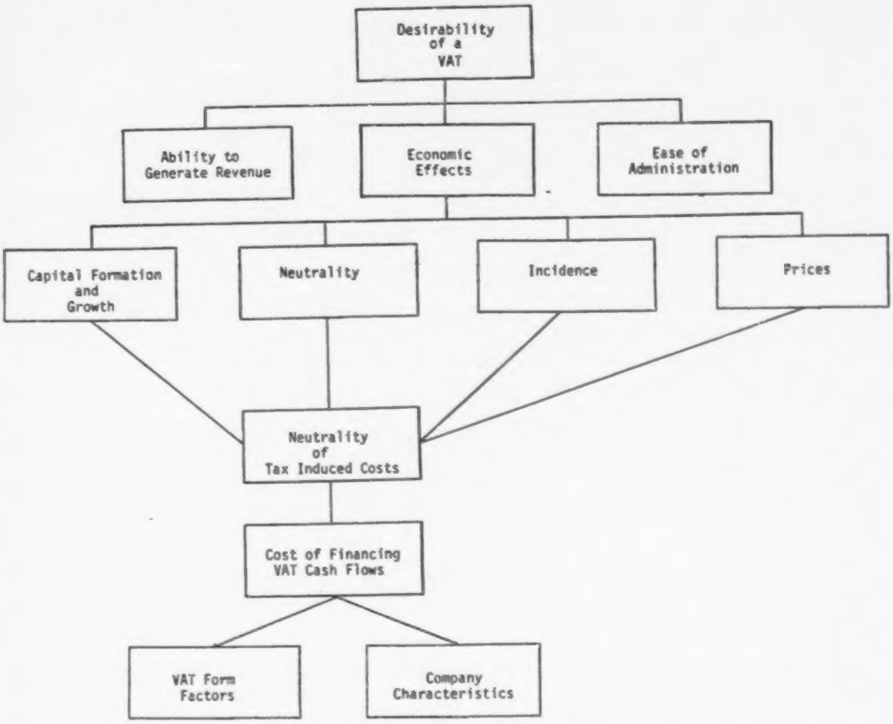
Desirability of a VAT
Ability to Generate Revenue
Economic Effects
Ease of Administration
Capital Formation and Growth
Neutrality
Incidence
Prices
Neutrality of Tax Induced Costs
Cost of Financing VAT Cash Flows
VAT Form Factors
Company Characteristics

FIGURE 1. Vat Policy Considerations

The author has investigated those company cash flow effects and their policy implications.[4] Specifically that research investigated three aspects of VAT cash flow financing:

1. the amount of the cost of financing burden (benefit) for various VAT forms
2. the neutrality of the distribution of the financing burden (benefit) among companies
3. the impact of company input mixes on the distribution of that burden (benefit)

DISCUSSION OF VAT CASH FLOW PROBLEM AREA

The aspects listed above can best be expressed by the following series of questions. A discussion follows each set of questions.

Cost of financing

What is the cost of financing the different forms of VAT? Is this cost significantly different between forms of VAT? Which factors have a significant effect on the cost of financing a VAT?

The cost of financing VAT cash flows is especially important to individual companies because this cost is dependent upon the characteristics of that particular company as well as the detailed provisions of the VAT law, i.e. the VAT form. In structure, the value-added tax is a proportional tax on the sales of a company which allows a credit for the VAT paid by the company on goods and services it purchases from other companies. The VAT has two cash flow streams; one for the tax on inputs, the other for the tax on sales.

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[4] Robert P. Crum, "The Short-Run Neutrality of Selected Value-Added Tax Forms With Respect to Financing," D.B.A. dissertation, The University of Kentucky, 1983.

The first step in investigating VAT cash flows was the determination of the possible major forms the VAT can take. A review of the literature [5] and VAT provisions in other countries [6] indicated that five major factors impact the amount and timing of VAT remittances. These form factors are:

(1) Exclusions and variations in rate (especially inclusion vs. exclusion of exports);

(2) Cash vs. invoice recognition;

(3) Allowance and timing of credits for VAT paid on capital goods [7] (consumption, income, or gross product type);

(4) Period vs. product inventory recognition; and

(5) Length of the tax accounting and deposit/refund periods (especially monthly and quarterly deposit schedules).

That literature also identifies company characteristics which may affect VAT cash flows and financing: (1) The amount and timing of sales and purchases; (2) the amount and timing of capital expenditures and depreciation; (3) sales collection and purchases payment periods; and (4) inventory levels.

Neutrality

How neutral is each form with respect to financing, i.e. how much variability in cost of financing would exist among companies for each form of VAT? Is this variability significantly different between forms of VAT? Which factors have a significant effect on the variability in cost of financing a VAT?

The neutrality of the VAT is potentially a major consideration of policy makers in deciding whether to adopt a VAT. Moller has stated: "The neutrality principle is just as important to TVA (VAT) as the ability-to-pay principle is to (the) income tax." [8] European experience has shown that VAT cash flow patterns, and their financing burden (benefit), have been concerns of both policy makers and companies.[9]

The degree to which financing burdens (benefits) are distributed evenly among companies and inputs can be labeled "the neutrality of the value-added tax with respect to financing." This study operationalized this concept by investigating the variance of the cost of financing the VAT relative to net VAT remittances among companies.

Since the cost of financing VAT cash flows for any one company is dependent upon its unique characteristics, one can expect differences to occur in the financing burdens of companies. Also important is the fact that the cost of financing VAT cash flows is dependent upon the form of VAT. The various VAT forms treat certain firm-specific variables differently. The form, therefore, may significantly affect the distribution of financing burdens upon companies.

Input Mix

How much of the variability in cost of financing, for each form of VAT, is explained by the input mix?

As noted above, VAT form factors and company characteristics co-determine the cost of financing the VAT. Among these characteristics are the amounts of labor, capital goods and purchased inputs used by the company in producing its goods or services. The VAT paid or not paid on inputs is treated differently for labor, capital goods, and purchased inputs. Thus, a company's cost of financing is likely to be dependent upon its relative input mix—the ratio of labor, capital goods, and purchased inputs used by the company. Those inputs associated with a higher cost of financing become relatively more expensive to use than those associated with a lower cost of financing.

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[5] For example: Michael Schiff, "Business Experienced with Value Added Taxation" (New York: Financial Executive Research Foundation, 1974), p. 88; L.L. Bravenec and Kerry Cooper, "Flexibility of the Value-Added Tax," Texas Law Review 55 (February 1977), pp. 453, 457–458; Smith, Webber and Cerf, Value Added Taxes, pp. 149–150; Carl S. Shoup, "Theory and Background of the Value-Added Tax," Proceedings of the Forty-Eighth Annual Conference on Taxation, 1955 (Sacramento: National Tax Association, 1956), p. 15.

[6] See Table 1, "VAT Forms in Selected Countries" in Crum, "Neutrality of VAT Financing," p. 24 where the VAT laws of Argentina, Belgium, Brazil, Denmark, France, Ireland, Italy, Luxembourg, Mexico, Netherlands, Norway, Sweden, United Kingdom, West Germany, and the legislation of Japan are analyzed according to the five factors mentioned here. That table also includes references to other works which analyze the VAT forms of other countries.

[7] A credit for the VAT on capital good purchases is allowed in the period of purchase under the consumption type, but is allowed in the period of depreciation under the income type. No credit is allowed under the gross product type.

[8] Mogens E. Moller, "On the Value-Added Tax in Denmark and the European Economic Community and the Renaissance of Tax Neutrality," Bulletin for International Fiscal Documentation 21 (October 1967), p. 436.

[9] For example: Stephen M. Brecher, D.W. Moore, M.M. Hoyle, and P.G. Trasher, "The Economic Impact of the Introduction of VAT" (Morristown, NJ: Financial Executives Research Foundation, 1982), p. 59; B. Kenneth Sanden, "The Value-Added Tax: Its Applications and Practice" Proceedings of the Sixty-Fourth Annual Conference on Taxation, 1971 (Columbus, Ohio: National Tax Association, 1972), pp. 296–297; B. Kenneth Sanden, "The Value-Added Tax—What It Is: How It Works—Experience in Foreign Countries," Tax Policy 39 (October–December 1972), pp. 9–10; George H. Bunge, "Financial and Accounting Procedures Under VAT," Tax Policy 39 (October–December 1972), p. 85; Moller, "Renaissance of Neutrality," pp. 35, 443.

In summarizing prior work in the VAT cash flow financing area one can make three observations. First, the cost of financing VAT cash flows and the distribution of their related financing burden (benefit) have been important in those countries adopting a particular VAT. Second, the cost of financing VAT cash flows in countries adopting a VAT has affected its overall desirability. Third, no prior empirically based study has been published on how the cost of financing varies between companies for different VAT policies.

METHOD OF INVESTIGATION

In order to investigate the above problem areas, a general VAT financing model was developed.[10] The model formalized and expanded the calculation procedures developed by Smith, Webber and Cerf.[11] Their examples were used to test the model. Not all of the factors, and resultant forms, listed earlier are investigated. Therefore, a reduced version of the general model including only those variables required for the forms under investigation, was used for the empirically based portion of the study.

Because of limited data availability, gross product and product recognition forms were not investigated. Therefore, the study was limited to sixteen VAT forms. These forms consist of all combinations of: (factor A) inclusion vs. exclusion of exports; (factor B) cash vs. invoice recognition; (factor C) consumption vs. income type; and (factor D) monthly vs. quarterly deposit schedule.

These forms include those most often proposed for adoption in the U.S. and used in other countries.

The net tax remittance and cost of financing were estimated for each company, year, and form using the reduced model. The sample consisted of 51 listed "industrial" companies for the years 1978–81. This sample included those companies, from a random sample of all listed "industrial" companies, which reported the data inputs required for the model. Data used for these procedures were obtained from Compustat and FASB # 14 disclosures.

A parametric analysis of variance (ANOVA) was used to test the significance of the differences in mean cost of financing between VAT forms and VAT factors. Duncan's multiple range test was used for pairwise form comparisons. Hartley's F max was used to test the significance of the differences in the variances of cost of financing between VAT forms and VAT factors. Regression analysis was used to test whether a significant portion of the variability in the cost of financing each form can be explained by differences in relative input mixes. In all cases a .05 significance level was used. In each case the parametric significance levels were confirmed using rank transformation procedures. Significance levels were also confirmed assuming total dependence between years, as well as total independence.

Certain limitations of this method of investigation should be noted. The scope was limited to a micro, short-run (preshifting) single level analysis of the effects of adding a VAT to the current tax structure. The population consisted of large "industrial" companies listed on the major exchanges, and therefore, excluded small and privately owned companies. Results obtained for the four years under study have limited extendability to periods involving changes in the structure of the economy and general economic conditions. The measurement model was based upon certain reasonable assumptions. An inherent limitation is that the model cannot capture all of the relationships having an effect on cost of financing. The study used yearly financial data. The high aggregation level does not permit conclusions about the effects of seasonal cash flows. The use of financial data limits the conclusions to situations where VAT definitions, recognition principles and application methods are comparable to those used for financial purposes.

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[10] For details of the general VAT financing model development see: Crum, "Neutrality of VAT Financing," pp. 89–120.

[11] Smith, Webber and Cerf, Value Added Tax, pp. 139–154.

RESULTS

Financing and remittance amounts (Means)

Table 1 contains estimates of the mean cost of financing per dollar of VAT remittance over the 51 companies and four years (1978–81) for each of the VAT forms. The mean cost of financing per net VAT remittance was found to be significantly different between forms. In their order of importance, factor C (consumption vs. income type), factor B (cash vs. invoice recognition), and factor A (inclusion vs. exclusion of exports) were found to have significant effects on the cost of financing per tax remittance means.

TABLE 1

Comparison of Cost of Financing Per Remittance Means

VAT FACTORS				MEAN	DUNCAN GROUPING
consump.	cash	qtr.	inc.	.0220	A
			exc.	.0220	A
		mth.	inc.	.0134	A
			exc.	.0134	A
	invoice	qtr.	inc.	-.0180	B
			exc.	-.0202	B
		mth.	inc.	-.0266	B
			exc.	-.0287	B
income	cash	inc.	qtr.	-.1236	C
			mth.	-.1307	C D
		exc.	qtr.	-.1436	C D E
			mth.	-.1505	C D E F
	invoice	inc.	qtr.	-.1563	D E F G
			mth.	-.1635	E F G
		exc.	qtr.	-.1769	F G
			mth.	-.1839	G

A mean was significantly different from all means not having the same grouping letter. Two means which have the same grouping letter were not significantly different. Positive amounts represent financing benefits to companies; negative amounts represent financing costs.

These results contrast with supplemental remittance and gross cost of financing results. Only factor C was found to have a significant effect on remittance means. Only Factor C and B were found to have significant effects on gross cost of financing means (total financing cost to a company—before division by the remittance).

Neutrality (Variances)

Table 2 contains the cost of financing per remittance variances among companies. The neutrality (variability), among companies, of the cost of financing per net VAT remittance was found to be significantly different between forms. Factor C (consumption vs income type) was found to have a significant effect on cost of financing per remittance neutrality (variances). Results also indicated that within consumption type forms, factor B (cash vs. invoice recognition) has a significant effect on cost of financing per remittance neutrality. In contrast, supplemental remittance results indicated that no individual factor has a significant effect on remittance variability.[12]

TABLE 2

Comparison of Cost of Financing Variances

VAT FACTORS				VARIANCE	GROUPING
income	exc.	invoice	qtr.	.066054	A
			mth.	.065219	A
		cash	qtr.	.052004	A
			mth.	.050998	A
	inc.	invoice	qtr.	.040261	A B
			mth.	.040034	A B
		cash	qtr.	.028537	B
			mth.	.028070	B
consump.	invoice	mth.	exc.	.015937	C
			inc.	.015827	C
		qtr.	exc.	.015688	C
			inc.	.015582	C
	cash	mth.	exc.	.000014	D
			inc.	.000014	D
		qtr.	exc.	.000005	E
			inc.	.000005	E

A variance was significantly different from all variances not having the same grouping letter. Two variances which have the same grouping letter were not significantly different.

Input mix

Differences in relative input mixes were found to account for a significant amount of the variability in costs of financing per remittance for income type forms. Supplemental results found input mix significant for all form remittances.

IMPLICATIONS

Remittance Cash Flow Implications

Remittance amount.—Significant differences were found in the remittances between consumption and income forms (factor C). Income forms generated more revenue than consumption forms. This difference resulted from generally larger capital expenditure credits than depreciation credits. Potential reasons for these credit differentials include a combination of the growth orientation of the companies sampled, inflationary pressure on expenditures for replacing existing capacity, and general economic expansion. In addition to the financing reasons addressed below, the credit differentials are important for cash availability reasons. Through successively larger expenditures, positive cash flow effects (lower remittances) can be maintained indefinitely; making more cash available for expenditure. Therefore, one may expect the consumption type to be more conducive to (stimulate) capital formation and growth than the income type. More study is required of the contribution of each of these contributing factors, particularly of the revenue generation power of the VAT forms under recessionary and deflationary conditions.

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[12] Groupings indicated possible factor C and factor B effects.

The effect of factor A was not large enough to be considered significant. Since the model accounts for 95.9 percent of the remittance variation, this result indicates that the treatment of exports had relatively little effect on the overall revenue generation power of the VAT.[13]

Though not statistically significant, invoice forms tended to generate higher revenue than cash forms. This relationship can occur due to a trend of increased sales with constant collection periods; constant sales with longer collection periods; decreased purchases with constant payment periods; and/or constant purchases with decreased payment periods. Part of any increase (decrease) in nominal sales and purchases may be due to inflation (deflation). Besides the direct effect on the volume of sales and purchases, general economic conditions may result in changes to credit terms. Any general trend to lengthen credit terms would tend to result in smaller VAT collections under the cash method as long a value added is positive. Therefore, the effects of inflation and general economic conditions on VAT remittances need to be studied in depth.

Remittance variance.—Remittance variances differed significantly across forms, though significant individual factor effects were not found. The consumption forms tended to result in lower remittance variances than income forms. A possible explanation for this difference is higher positive correlation between sales and capital expenditures than depreciation. If so, smaller differences can be expected for consumption forms during growth periods.

Association of input mix and remittance.—Except for exports, remittance differences are timing differences. Input mix was significant in relation to remittance variation for all forms. This finding supports the contention that for all forms companies have relative advantages (disadvantages) due to deferred (accelerated) remittances, depending upon input mix. Therefore, the VAT forms under study are not inherently neutral with respect to inputs.

Cash flow financing implications

Amount of financing.—For the companies and years sampled, consumption—cash forms resulted in overall financing benefits. These forms could be expected to have a stimulant effect on the economy. Other forms exhibit varying degrees of cost, i.e. depressant effects would be expected.

Company costs of financing.—The range of the form means was smaller and less extreme on both tails for the overall (weighted) cost of financing/tax remittance means than for the company (unweighted) cost of financing per remittance means. This indicates that companies with large remittances tended to be more insulated from VAT form effects than those with smaller remittances. This finding implies discrimination effects based upon size. Further research needs to be done in this area. This finding also suggests significant company differences which are not revealed at an aggregate level. The comparison of significant factors for weighted and unweighted means supports the micro approach. For gross (weighted) cost of financing only factors C and B were significant. For (unweighted) cost of financing per remittance factor A was also significant.

Not all form factors have the same influence on the cost of financing a VAT. The order of their influence becomes important for making trade-offs to meet the many tax policy objectives, and for companies and lobbyists in effectively representing their interests.

Type (factor C) was found to be most important. Consumption type forms had lower financing costs than their income counterparts. Capital intensive industries probably would be most concerned with this factor. More study is needed in the area of the coefficient links between input mix and cost of financing.

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[13] This implication is tentative considering the data precision limitation imposed by FASB #14 disclosure requirements.

The second most important factor was recognition (factor B). Though some companies fared better using the invoice method, most had smaller financing costs using the cash method. More study of the effect of allowing an option is needed.

Inclusion vs. exclusion of exports (factor A) was third—with higher importance for income type forms than consumption. The significance of this factor implies that policy makers should consider the financing effects of excluding exports along with lost revenue and potential export stimulus effects of that exclusion.

Factor D (deposit period) was found to be least important (not significant). The relative inferiority of this factor implies that minor changes in the deposit period would have little relative impact on cost of financing. Where remittances are due, longer deposit periods benefit companies. The government, however, can generate the effect of a one-time increase in the tax base by accelerating deposits. Additional financing burdens, and the administrative feasibility and burden of shorter more numerous deposit periods, should be weighed against the revenue effects of such a plan.

Cost of financing neutrality.—The neutrality of the cost of financing per remittance was addressed, i.e. remittance magnitude effects were removed. Consumption—cash forms were significantly more neutral with respect to financing than other forms of VAT. However, consumption—cash forms also generated lower revenue. Therefore, revenue/economic effects trade-offs will be necessary.

Significant differences in neutrality were found between consumption and income forms. The larger variability of income forms is expected due to differences in depreciable lives of capital assets. Within consumption type forms, cash forms were significantly more neutral. This difference was due to the importance of collection and payment periods for invoice forms.

From a policy standpoint, the wide variety of neutrality is likely to make VAT form a policy issue. Least neutral forms are likely to be more controversial, because those benefiting or burdened have more to gain or lose. These neutrality measures can also be viewed by companies as indicators of the potential reward from tax planning.

Association of input mix and cost of financing.—Part of the tax planning and advantage (disadvantage) referred to above can be expected in the area of relative input mixes. Input mix was significant in relation to variation in cost of financing per remittance for income forms. For remittances, input mix was significant for all forms. One reason for this contrast is that the remittance amount effect had been normalized by the division. Therefore, additional savings related to the size of the remittance itself may also be possible.

These results indicate that input mix has an effect (larger effect for income forms) but that other variables also affect the cost of financing. Therefore, each company would need to study its own situation to determine its relative advantage or disadvantage and possible courses of action. The greatest potential for planning is with income forms, since they were found not to be neutral with respect to financing as to input mix.

The results indicated that the EEC VAT (consumption-invoice-monthly-excluded) would have been more neutral and have generated less revenue than an income form, if applied to the sampled U.S. companies for 1978–81. However, among consumption type forms this form was found to be least neutral from a cost of financing standpoint and would not have taken full advantage of the U.S. revenue potential during the 1978–1981 period.

SUMMARY

The value-added tax has been considered desirable because of its revenue generation potential. However, the economic effects of collecting that revenue through different forms of VAT have received considerably less attention. More specifically, the cost of financing VAT cash flows has been a neglected area in the VAT literature.

Partly because of the lack of prior work in the area, the study summarized above was exploratory in nature. Therefore, it tended to raise more issues for future study than it resolved. The study represents the first study attempting to systematically address VAT cash flow issues using an empirical data base.

The enumeration of major VAT forms arms researchers and legislators with alternatives for consideration. Quantification of the cost of financing and neutrality of the various VAT forms has potential policy implications. Policy makers and lobbyists are provided with information about certain aspects of the economic effects of VAT forms which was not previously available. For example, this study provided the first known estimates of cost of financing and neutrality based on a sample of

U.S. companies. Possibly more important, the implications identify those areas which are likely to be issues and fruitful for future research.

The study indicates that tough policy decisions lie ahead if a VAT is to be adopted. For example, though consumption—cash forms were found to be most neutral they also generated the least revenue under the economic conditions prevalent for the period under study.

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STATEMENT OF DALLAS L. SALISBURY,* PRESIDENT, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Dallas Salisbury is President of the Employee Benefit Research Institute, a non-profit, non-partisan, public policy research organization. Before joining EBRI he served in senior career policy research positions at the U.S. Department of Labor and the U.S. Pension Benefit Guaranty Corporation. The statement draws heavily from research studies conducted and published by EBRI.

SUMMARY

Tax reform is an appealing concept that attracts broad based support when discussed in the context of eliminating abuse. My full statement, and a book now being published by EBRI titled *Retirement Security and Tax Policy,* discuss the various tax reform alternatives.

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*The views expressed in this statement are solely those of Dallas Salisbury and should not be attributed to the Employee Benefit Research Institute, its officers, trustees, sponsors or other staff.

Proposals set forth are characterized by single words: Flat, FAST, consumption, etc. Yet, few on the street fully understand what is involved in obtaining "reform" and "simplification." I hypothesize that few workers who favor "tax reform" understand that many proposals would treat non-cash compensation as taxable income. Would they be less interested in "tax reform" if they did? Action may be appropriate, but an effort should be made to assure clear public understanding if there is to be confidence in the new system.

Revisions in the tax treatment of employee benefits considered in the context of major tax reform should include several considerations: First—distributional impact—the middle-income worker will be the major victim of any such changes. Second—progressivity desired—some treatments would be more regressive than others. Third—transition—reform would create significant reductions in public welfare and would exacerbate intergenerational tensions. Fourth—simplification—taxing benefits would actually be more complex than the current system. Fifth—the potential revenue gains from taxing benefits should be compared with additional demands that could result on the expenditure side of the budget.

Federal, state, local and private employer-sponsored retirement plans account for 5.3 percent of total compensation. Three and one-half percent of total compensation finances employer-sponsored group health insurance. Of all full-time employees in medium and large establishments, 82 percent are covered by a pension plan. 96 percent of this group of employees are covered by health and by life insurance plans. Retirement benefit payments exceed $80 billion for a $50 billion tax expenditure, with benefits growing rapidly to complement Social Security. Benefit payments approach $80 billion for a $17 billion tax expenditure.

The average taxpayer demanding tax reform does not see employee benefits as tax abuse. Rather, both employers and employees see these benefits as part of the social contract that defines how, with the assistance of employers, individuals provide for themselves, their families, and their future. This social contract and related tax benefits affect over 150 million Americans. In 1981, employees earning between $15,000 and $50,000 received 71.8 percent of all health-related tax preferences, 64.5 percent of all pension-related tax preferences, and 67.5 percent of all insurance-related preferences.

Tax reform is a legitimate policy objective. We must be certain, however, that the "reform" ultimately enjoys greater public support than the present system. Inability to achieve this goal with major tax reform may tell us why all industrialized nations have complex tax codes.

INTRODUCTION

Mr. Chairman, I am pleased to submit this statement to the Committee in order to assist it in its discussion of major tax reform options and consequences. My statement primarily focuses on employee benefits. Employee benefits are a key element of the nation's economic security structure, and have been at the center of tax reform discussions. In a recent interview on tax reform, John Chapoton, then Assistant Secretary of the Treasury for Tax Policy was asked to define broadening the tax base. He responded: "A lot of income that taxpayers receive today goes untaxed—employer contributions to pension plans, health insurance, free parking, goverment payments, those benefits. . . . To produce enough revenue, the flat tax would have to apply lower tax rates to more types of income with fewer deductions."[1]

To aid the Congress in considering tax reform proposals, I would like to provide some background on employee benefits, the tax benefits they receive, and the social benefits they provide (see Appendix I). In my testimony today I will discuss: The goals of employee benefits; who receives employee benefits; who receives the tax incentives for these programs; and the consequences of alternative major tax reform proposals for employee benefits and, therefore, economic security.

The Employee Benefit Research Institute (EBRI) was formed in 1978 as a nonprofit, non-partisan, public policy research organization to conduct research and educational programs. EBRI is committed by charter to the premise that the nation is served positively in both social and economic terms by the existence of employee benefit programs; they can be clearly shown to improve economic security. We are aware, however, that there may be limits to what can and should be provided for both social and economic reasons. EBRI undertakes to provide the studies and the statistics that will allow informed priority decisions to be made based upon assessment of documented costs and benefits.

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[1] "Our Complex Tax Laws: Can They Be Reformed? *U.S. News & World Report,* July 30, 1984.

The press release on this hearing stated: "Our interest as a Committee is in building a tax system that will be supported by a broad consensus so that the goals of equity and efficient revenue-raising will not be undermined in the years ahead."

Our research indicates that the present tax treatment of retirement, health, and other risk related benefits meets this criterion. The current tax rules meet the Committee criteria of equity, simplicity, balance and economic efficiency. They have broad public support: Social Security, Medicare, Medicaid, employer pensions, employer health, life and disability protection work together to meet a major component of the nation's economic security needs.

These basic benefits are not "tax-ripoffs, are not viewed by the public as "abusive tax-shelters," and are far too significant to be termed "fringes." Further, consideration of the appropriate tax treatment of these benefits should be clearly separated from debates over "consumption fringes."

The goals of employee benefits

Employer contributions for all public employer, private employer, and social employee benefits in 1982 constituted 15.8 percent of employee compensation according to Department of Commerce estimates (excludes vacation).[2] These payments constitute most workers' main source of protection against the hazards that may keep them from providing for themselves, their families, and their futures. Together, employer contributions for retirement and health programs, including Social Security and Medicare, account for 85 percent of employer payments for benefits.

Retirement plans.—Employer contributions for retirement plans total 9.0 percent of compensation. Federal, state and local and private employer-sponsored retirement plans account for 5.3 percent of total compensation. Contributions for Social Security retirement and disability benefits account for the remaining 3.7 percent.

Health insurance.—Employer contributions for health insurance account for 4.4 percent of total compensation. Of this total, 3.5 percent of total compensation finances federal, state, local and private employer-sponsored group health insurance. The remaining 0.9 percent is accounted for by employer contributions for the Medicare component of the Social Security program.

Other risks.—Employer contributions also finance unemployment insurance, worker's compensation, and life insurance. These programs protect workers and their dependents against economic uncertainty, and death. Payments for these benefits total 2.4 percent of total compensation.

Fringe benefits.—Recent debates over tax legislation have focused on other benefits in addition to the major or traditional categories. The Tax Reform Act of 1984 codified the treatment of benefits like employee discounts and subsidized cafeterias. These benefits are too small as a share of compensation for the Department of Commerce to estimate their value. According to Chamber of Commerce data, these benefits account for 0.6 percent of total compensation.

While traditional benefits make up the largest part of employee benefits, employee benefits have also begun to evolve to meet the needs of the changing work force. Census data show that over the last decade, the proportion of single-adult households with children increased by one-third. Over half of married women are now in the labor force. Single-adult and two-earner households have different benefit needs from those of the traditional single-earner, two-parent family. Many employers now provide child-care benefits, as well as flexible benefit plans that allow single-parent and two-earner families to tailor their benefits packages to meet their specific needs. Cost data on these benefits is not currently available.

Who receives employer sponsored employee benefits?

These benefits are now provided across the income distribution. In medium and large establishments, coverage for major empmloyee benefits is nearly universal. Employee benefits are now a mainstay of the middle-income worker's economic security, building savings as well as providing hazard protection.

Employer pensions

Of all full-time employees in medium and large establishments, 82 percent are covered by a pension plan (table 1). Small firms, for numerous economic reasons, do not sponsor plans as uniformly. In 1981 the President's Commission on Pension Policy concluded that this could only be changed by mandating plans or by offering tax credits. As firms grow, however, they do add retirement programs. Among employees in all establilshments who were covered by pensions in 1983, nearly 28 million (or 59.0 percent) earned less than $20,000 (table 2).

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[2] This total includes Social Security contributions; unemployment insurance; workmen's compensation; private pensions and profit-sharing plans; federal state and local government employee retirement plans; group health insurance, group life insurance; and supplemental unemployment benefits.

TABLE 1.—PERCENT OF FULL-TIME EMPLOYEES PARTICIPATING IN SELECTED EMPLOYEE BENEFIT PROGRAMS, MEDIUM AND LARGE ESTABLISHMENTS, 1983 [1]

Employee benefit program	Percent of employees
Private pension plan	82
Health insurance:	
Employee	96
Dependents	93
Life insurance	96
Long-term disability insurance	45
Sickness and accident insurance	49

[1] Detail may not add to totals due to rounding. Totals include only those civilian health and pension plan participants who reported their earnings in the Survey. When those not reporting their earnings are added, coverage totals are higher.

Source: U.S. Department of Labor, Bureau of Labor Statistics, "Employee Benefits in Medium and Large Firms, 1983," May 1, 1984.

TABLE 2.—DISTRIBUTION OF EMPLOYEES WITH PENSION AND HEALTH COVERAGE BY EARNINGS

Earnings	Employees with pension coverage, 1983		Employees with health coverage, 1983	
	Total (in millions)	Percent	Total (in millions)	Percent
Less than $20,000	27.9	59.0	83.7	74.3
$20,000 to $49,999	18.1	38.0	26.2	23.2
$50,000 and over	1.4	2.9	2.7	2.4
Total [1]	47.4	100.0	112.6	100.0

Source: EBRI tabulations of U.S. Census Bureau Current Population Survey, 1983 and EBRI-HHS Current Population Survey Pension Supplement.

Pensions redistribute wealth to favor those at the lower end of the income scale who do not tend to save much out of current income. According to the EBRI/U.S. Department of Health and Human Services (HHS) May 1983 Current Population Survey (CPS) Pension Supplement, accumulated pension benefits constitute the major form of savings for more than half of all persons with pension coverage. More than 40 percent of the labor force reported no savings income in 1983 (table 3). This group's average income was $9,651, just under half the average income of those reporting some asset income. Almost half of the group reporting little or no savings income were covered by employer pensions, however. Pensions thus constituted a net increase in savings for these workers. As the Committee press release noted, assessments of pension-related tax policies should consider the net increase and redistribution of wealth that results from expanded pension coverage.

Not all retirement benefits exhibit the same income distribution patterns, however. In particular, statutory provisions aimed at encouraging individual provision for retirement differ considerably. While 59 percent of pension participants earn less than $20,000, 46.5 percent of individual retirement account (IRA) holders and 34.8 percent of those participating in Section 401(k) plans fell into this income group (table 4). Section 401(k) plans in particular follow a different income distribution from both IRAs and employer-sponsored plans. More than half of Section 401(k) plan participants earn between $20,000 and $50,000, compared with under 50 percent for both IRAs and employer-sponsored plans.

TABLE 3.—SAVINGS, PENSION COVERAGE, AND INCOME, 1983

Savings status [1]	Employees covered [2] (Millions)	Employees covered [2] (Percent)	Employees not covered (Millions)	Employees not covered (Percent)	Average annual income (Dollars)	Average annual income (Percent)
No savings	18.2	19.0	20.6	21.5	$9,661	40.5
Some savings [3]	36.9	38.4	20.3	21.1	19,209	59.5
Total	55.1	57.4	40.9	42.6	15,338	100.0

[1] Individuals are classified as having some savings or no savings based on whether or not they reported any asset income in response to the survey questions. Asset income includes interest, dividends, rents, and royalties.

[2] Coverage refers to public- and private-sector pension plans and includes holders of IRA or Keogh accounts.

[3] Includes individuals reporting negative asset income (i.e., decreases in asset values).

Source: Sophie M. Korcyzyk, Retirement Security and Tax Policy (Washington, D.C.: Employee Benefit Research Institute, forthcoming).

TABLE 4.—PERCENT DISTRIBUTION OF PARTICIPATION IN RETIREMENT PROGRAMS, BY EARNINGS, 1983

Earnings	Pension plan	401(k)	IRA
$1 to $19,999	59.0	34.8	46.5
$20,000 to $49,999	38.0	55.7	45.4
$50,000 and over	2.9	9.5	8.0
Number of workers (in millions)	47.4	1.9	16.7

Source: EBRI tabulations of U.S. Census Bureau Current Population Survey, 1983 and EBRI–HHS Current Population Survey Pension Supplement.

Health insurance

Of all full-time employees in medium and large establishments, 96 percent are covered by health and by life insurance plans (table 1). Among all employees with employer-provided health coverage, 83.7 million (or 74.3 percent) earned less than $20,000, and 23.2 percent earned between $20,000 and $50,000. About 35 percent of all spending on health care that does not pass through government programs is now made through employer-sponsored plans.[3] Fewer than 3 percent of pension and health insurance participants earn more than $50,000.

Employee benefits and the tax code

The tax code is a major influence in the growth of employee benefits. One effect results from provisions that allow some employer contributions and some employee contributions to finance benefits on a tax-preferred basis. Another major impact stems from the inflation-driven increases in real tax rates of the last 20 years. While statutory tax rates have been falling at most income levels, real tax rates have risen. Inflation has overwhelmed the tax rate cuts enacted over this period. To stem the erosion of real income brought about by this "bracket creep," employees have negotiated compensation packages in which benefits have played an increasingly important role. It is interesting to note, however, that this trend has abated with increasing emphasis on 401(K) salary reduction programs that are subject to FICA tax and employer attention to health care cost-containment.

Employee benefits are also now playing a major role in tax policy. As directed in the Congressional Budget Act of 1974, the President's annual budget submission to Congress lists each year's tax expenditures. These are benefits perceived to flow to certain taxpayers as a result of the statutory treatment of certain sources or uses of income.

Of the 51 tax expenditure provisions that benefit individuals, 20 or nearly 40 percent, affect the tax treatment of privately- and publicly-provided employee benefits. This seems consistent with the nation's commitment to economic security. Two provisions—those governing the tax treatment of employer-sponsored retirement plans and health insurance plans—account for nearly two-thirds of total benefit-related tax expenditures projected in the President's 1985 budget.

Employer pensions account for nearly 50 percent of benefited-related tax expenditures. There is wide disagreement, however, about the proper way to measure these costs. Tax-expenditure measures used in the federal budget process are calculated on a cash-flow or cross-sectional basis, with the taxes deferred by current pension plan participants offset against the taxes paid by current beneficiaries. Measured this way, about $0.83 out of every tax-deferred dollar appears to be lost to the Treasury.

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[3] Unpublished EBRI estimate.

Recent EBRI research, however, suggests that such estimates overstate the amount of revenue lost due to these provisions. Because today's pension-plan participants will have higher retirement incomes than today's retirees, they will pay more taxes in retirement. Over their lifetimes, employees now at the beginning of their pension careers will repay all but $0.25 to $0.40 of every tax-deferred dollar. As the pension system matures, the numbers and income levels of pension-plan participants and retirees will differ less than they do today. As a result, in the future, pension-related tax expenditures measured using the Treasury's approach will be much closer to lifetime estimates.[4]

From the standpoint of long term social and economic policy, however, the difference between tax exemption and tax deferral must always be noted: these programs both reduce demands on Social Security and contribute to the public consensus for Social Security (table 5).

TABLE 5.—PERCENTAGE OF HOW MUCH PENSION-RELATED TAX DEFERRALS IS LOST TO THE TREASURY

Method used	Taxes lost	Taxes deferred
Treasury method	83	0
Lifetime method:		
Nominal dollars [1]	14	86
Real dollars [2]	28	72
Discounted for interest: [3]		
At pension rate	40	60
At Federal rate	36	64

[1] Before adjusting for inflation.

[2] After adjusting for inflation.

[3] Interest rate used to discount taxes paid in retirement to the year of retirement.

Source: Sophie M. Korczyk, "Retirement Security and Tax Policy" (Washington, DC: EBRI, forthcoming).

Who benefits from tax incentives?

The average taxpayer demanding tax reform does not see employee benefits as a tax abuse. Rather, both employers and employees see these benefits as part of the social contract that defines how individuals provide for themselves, their families, and their future. This social contract and related tax benefits includes the majority of the U.S. labor force.

The distribution of benefit-related tax benefits among income groups reflects the distribution of coverage and participation. In 1981, employees earning between $15,000 and $50,000 received 71.8 percent of all health-related tax preferences, 64.5 percent of all pension-related tax preferences, and 67.5 percent of all insurance-related preferences (calculations based on table 6). This group pays 51 percent of total federal taxes. By comparison, this income group received 64.2 percent of tax benefits related to homeownership. It would seem that employee benefits are less of a luxury than owning your own home.[5]

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[4] For further detail on these estimates, see Sophie M. Korczyk, *Retirement Security and Tax Policy* (Washington, D.C.: EBRI, forthcoming), Chapter IV.

[5] EBRI calculations based on U.S. Congress, Congressional Budget Office, *Revising the Individual Income Tax* (Washington, D.C.: U.S. Government Printing Office, 1983), Table 9.

TABLE 6.—REVENUE LOSS FOR MAJOR BENEFITS AND TAXES PAID BY INCOME CLASS AS PERCENT OF TOTAL ADJUSTED GROSS INCOME CLASS, 1981 [1]

[In percent]

Adjusted gross income class	Exclusion of employer contributions for medical insurance and medical care	Exclusion of worker's compensation benefits	Exclusion of untaxed unemployment insurance benefits	Exclusion of disability pay	Net exclusion of pension contributions and earnings [2]	Exclusion of insurance premiums [3]	Percent of total taxes paid
Less than $10,000	6.5	29.4	50.6	83.0	4.0	4.5	2.6
$10,000 to $15,000	8.7	16.6	26.4	14.4	5.6	6.1	5.7
$15,000 to $20,000	10.7	11.7	9.7	6.7	7.8	8.8	8.0
$20,000 to $30,000	28.3	24.8	12.8	2.0	22.6	24.0	20.6
$30,000 to $50,000	32.8	12.9	0.4		34.1	34.7	30.4
$50,000 to $100,000	10.6	3.5			17.8	15.2	18.1
$100,000 to $200,000	1.9	0.7			6.0	4.8	8.3
$200,000 and over	0.4	0.3			2.1	1.9	6.3

[1] 1981 income levels and 1982 law.

[2] Includes the exclusion of contributions and earnings for employer plans and plans for the self employed and others.

[3] Includes premiums for group-term life insurance and accident and disability insurance.

Note: Percents may not add to 100 percent due to rounding.

Source: EBRI calculations based on U.S. Congress, Congressional Budget Office, "Revising the Individual Income Tax," July 1983 (Washington, D.C.: U.S. Government Printing Office, 1983), table 9, pp. 62 and 63.

The tax reform movement

Tax reform is a perennial topic of discussion. At least a dozen major tax reform proposals were introduced in the 97th Congress. More tax reform proposals were introduced in the 98th Congress. Some legislative proposals call on the Treasury to study major tax reform, while others contain detailed amendments of the Internal Revenue Code. President Reagan has also asked that the Treasury department analyze basic tax reform options and prepare a report by December 1984.

At the heart of the major tax reform movement is the widespread belief that the tax system is unfair and inefficient. The middle-income taxpayer feels that he or she is paying the bill for the loopholes of the wealthy.

The tax system is considered by some to be inefficient because investment and other economic decisions are often driven as much or more by tax needs as by economic returns and productivity considerations. High marginal tax rates encourage taxpayers to seek out tax-favored sources of income—capital gains, for example—and tax-favored uses of income, such as housing.

Major tax reform proposals offer ways to restructure—not lower—the nation's tax bill. Major tax reform proposals such as the flat tax, the "fast" tax, the consumption tax, and the gross income tax, would lower marginal tax rates and expand the income tax base. These proposals would change the distribution of tax liability among individuals by eliminating many tax preferences in current law. Another set of proposals would raise additional revenue through a broad based value added or sale tax.

The arguments for broadening the tax base have attracted a wide range of political support. Conservatives support broadening the tax base as a way of eliminating the income-earning disincentives and market interference of high marginal tax rates. They also prefer individual decision-making to employer or government decisions made on the worker's behalf. In this view, Individual Retirement Accounts (IRAs) are preferable to either Social Security or employer pensions as a means of providing for retirement.

Liberals support broadening the tax base as a way of eliminating tax-code provisions perceived to benefit primarily the rich. They also prefer direct government expenditures over the tax subsidies that might arise from tax incentives.

EMPLOYEE BENEFITS IN MAJOR TAX REFORM PROPOSALS

While tax reform has broad support, it would also have widespread costs. One of the most important consequences of tax reform proposals that seek to restructure the tax system for the average taxpayer would be to change the tax treatment of employee contributions for employee benefits.[6]

Comprehensive income tax

A comprehensive tax attempts to tax both actual and imputed income. Many comprehensive income tax proposals include in taxable income not only cash wages but also all or most employer contributions for employee benefits on a current basis.

Consumption tax

The consumption tax would tax all income that is spent, excluding saving from taxable income until the funds were used for consumption. The consumption tax would therefore tax all employer contributions for benefits that do not result in saving. This includes the various employee benefits that provide insurance protection, like health insurance plans, life insurance, and disability insurance. Since cash compensation would continue to be a tax-deductible cost of doing business to the employer, the employer would presumably have an incentive to offer more compensation in cash than in benefit contributions.[7]

Value-added tax

For any one employer, value added is the difference between receipts from sales and amounts paid for materials, supplies, and services purchased from other firms. Total value added for the entire economy is equal to total wages, salaries, interest, rents, and profits. Like the current income tax, the value-added tax could include or exclude employee benefits in the tax base.

Federal sales tax

A federal sales tax would have the same as some forms of the value-added tax. The difference is that a federal sales tax would be levied at the point of sale, while a value-added tax is imposed at each stage of production. Since a sales tax imposes tax liability on the total value of the product, it would implicitly tax employer outlays for employee benefits since these outlays are a cost of production. It would likely have little effect, however, on either employer or individual behavior regarding the provision of employee benefits.

ISSUES IN IMPLEMENTATION AND TRANSITION

This committee expressed an interest in implementation and transition issues in basic tax reform. These problems could be formidable, and even predicting them involves some uncertainty about the reactions of employers, employees, and insurers and other providers of benefits. This uncertainty arises from the fact that the availability of tax incentives for employee benefits has influenced how plans are provided and designed. For example, because employee benefits are purchased on a group basis, employers and employees can benefit from economies of scale. Therefore, a dollar spent on employee benefit by an employer buys more than would the same dollar spent by an individual. In the absence of tax incentives encouraging employer provision, the administrative structures that make group purchases cost-effective may never have been developed.

Alternate treatments for employee benefits that have been proposed include: Including benefit contributions in the employee's adjusted gross income; eliminating employer deductions for benefit contributions; capping the share of total compensation that can be provided in the form of tax-favored employee benefits; imposing an excise tax on the employer's benefit contributions; and imposing a value-added or national sales tax.

The issues and economic effects that arise under each approach differ considerably.

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[6] Alternative tax systems would require detailed judgments about the treatment of various sources and uses of income. Both would also create some formidable implementation and transition problems. These problems and issues are treated in detail elsewhere. For a discussion of employer pensions in basic tax reform, see Sophie Korczyk, *Retirement Security and Tax Policy* (Washington, D.C.: EBRI, forthcoming) and "Basic Tax Reform: Implications for Employee Benefits," EBRI *Issue Brief* no. 28, March, 1984. For a wide-ranging discussion of theoretical and practical issues in basic tax reform, see Dallas L. Salisbury, ed., *Why Tax Employee Benefits?* (Washington, D.C: EBRI, 1984).

[7] This argument is advanced in Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill Company, 1983), p. 90.

Including benefit contributions in adjusted gross income

Most plans do not determine the costs of employee benefits on the basis of the characteristics of the individual for whom protection is being provided. These pricing structures are reasonable from employer's viewpoint given current tax treatment, since the total cost of insuring the employer's work force is not affected by the allocation of these costs among the members of the covered population. They are irrelevant to the employee who cares only about the total amount of insurance provided, and not about how the cost of this insurance is billed to the employer.

If employer contributions for benefits were taxed to the employee, the entire pricing and cost allocation structure of benefit plans could have to be revised to allocate contributions appropriately among individuals. While the average price of providing employee benefits to various employees may be uniform, the underlying cost of benefits differs widely according to the employee's age under all major benefits. Benefits for younger employees are less costly because these employees generally have lower health insurance claims, disability rates, and mortality rates. The adjustments that would be required would vary across benefits.

Pensions.—Actuarial methods used in defined-benefit pension plans do not generally allocate contributions or projected benefits to individuals, determining them instead for an employee cohort based on aggregate forecasts of that cohort's future demographic and economic experience. If defined-benefit pension costs were allocated among individuals, it would become clear that financing a given retirement benefit requires a lower contribution for a younger employee than for one closer to retirement age. The contribution for the younger employee can accrue interest over a longer period of time, while the same benefit increment for an older employee has to be financed primarily out of employer contributions.

Pension costs in a defined-benefit plan may therefore be 14 times as high for an employee at age 60 as at age 30 (calculations based on table 7). Attributing an average pension contribution to each employee would create serious inequities. Older employees would be undercredited, while younger employees would be overcredited. To the extent that older employees earn more and are taxed at a higher rate than younger employees, this inequity would be compounded.

Health insurance.—Employer contributions to finance health insurance are similarly based on the total cost of insuring a particular employee group.[8] Underlying costs for health insurance can be twice as high at age 60 as they are at age 30 (calculations based on table 9). Similarly, the underlying cost of providing health insurance for women of child-bearing age is higher than the cost of insuring young, single men. In short, the average price of most employee benefits is much higher than the cost of providing benefits to some individuals and much lower for others.

Options for alternative tax treatment

If employer contributions for benefits were included in the tax base, they might be treated in the same way that the Internal Revenue Code now treats employer-paid life insurance premiums for coverage in excess of $50,000. These premiums are currently included in the tax base. The cost of life insurance varies according to the individual's age. For example, at age 30, the cost of providing life insurance worth an individual's annual salary is 17 percent as large as it is at age 45, while at age 60 this cost is nearly 4 times as large (calculations based on table 7).

TABLE 7.—BENEFIT COST FACTORS FOR EMPLOYEES AT VARIOUS AGES

Age group	Medical cost factor as percent of cost at age 45 to 49	Defined-benefit cost factor as percent of cost at age 45 to 49 [1]	Life insurance cost factor as percent of cost at age 45 to 49 [2]
Under 30	80.0	23	17
30 to 34	80	33	17
35 to 39	80	48	33
40 to 44	80	69	50

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[8] In smaller plans, the cost of providing health insurance for the marginal employee is based on the average costs of insuring the insured population of that community. In larger plans, the cost of insuring the marginal employee is based on the average cost of insuring the population represented by that employer's work force. While these two methods would be likely to yield different insurance costs for any given employee, under either method the cost of insuring that employee does not represent the cost of that employee's expected claims.

TABLE 7.—BENEFIT COST FACTORS FOR EMPLOYEES AT VARIOUS AGES—Continued

Age group	Medical cost factor as percent of cost at age 45 to 49	Defined-benefit cost factor as percent of cost at age 45 to 49[1]	Life insurance cost factor as percent of cost at age 45 to 49[2]
45 to 49	100	100	100
50 to 54	112.5	146	170
55 to 59	125	216	250
60 to 64	160	323	383
65 to 69	225	([3])	383

[1] Defined contribution plan costs do not vary by age.

[2] Same life insurance cost is assumed for 65 to 69 as for 60 to 64 because it is assumed that the benefits will be reduced to equal cost; regulations allow a 30 percent reduction. If benefits are not reduced, assume costs at 65–69 are about 30 percent higher. Figures assume life insurance provided is worth one times pay.

[3] Pension costs for these employees depend on the plan's design.

Source: Anna M. Rappaport, F.S.A. and Malcolm H. Morrison, Ph.D., "The Costs of Employing Older Workers" (Washington, D.C.: U.S. Senate Special Committee on Aging and the Employee Benefit Research Institute, forthcoming).

To avoid the inequities that would arise if all individuals were taxed on an average cost of insurance, Treasury regulations prescribe the amount of premiums to be recognized as income for individuals on the basis of age (in five-year brackets) and coverage levels. The Treasury tables use blended actuarial assumptions for men and women based on the proportions of men and women in the group of employees with coverage over $50,000 in value.

To achieve an equitable distribution of tax liability, a schedule like that governing the tax treatment of life insurance would probably have to be developed for all employee benefits. Given the Supreme Court's decision in the *Arizona* v. *Norris* case, such tables would probably not be differentiated by sex. Such tables could, however, be differentiated by age, family status, or both. Family status could be used to predict health insurance claims under plans that offer maternity or dependents' benefits.

Effects of taxing benefits

The effects of taxing benefits would vary among benefits and would depend on whether or not individuals chose to continue their coverage. If pension accruals were taxed on a current basis, saving would almost certainly decline, and would decline disproportionately among those at lower income levels who do not tend to save out of current income.

To avoid the added tax liability, many low- and moderate-income individuals would choose to do without health and other types of insurance. Research indicates that income determines whether or not people without employer-provided health coverage purchase such coverage themselves. If employers did not provide health coverage, most low-income workers would not purchase private health insurance.[9] Since most people covered by an employer health plan are members of low- and middle-income families, employer-provided health benefits probably substantially raise rates of private health insurance coverage throughout the nonelderly population.

For those who chose to continue their insurance coverage, the impact of a tax on health insurance premiums would be regressive. While employer contributions for life and disability insurance are based on the employee's earnings, contributions for health insurance are not. As a result, the value of employer-provided coverage is a larger share of total compensation at lower income levels and the added tax payment of low-income workers would be a larger share of their income than at higher income levels. EBRI tabulations of data produced by the Congressional Budget Office (CBO) indicate that under the Administration's proposal to cap the amount of health insurance premiums that an employee can receive tax-free, those with the lowest incomes would pay more than six times as much tax as a percent of income as those with incomes above $50,000.[10]

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[9] Deborah J. Chollet, *Employer-Provided Health Benefits: Coverage, Provisions, and Policy Issues* (Washington, D.C.: Employee Benefit Research Institute, 1984), p. 94. An EBRI simulation of private health insurance suggests that 56 to 87 percent of all covered workers with 1979 family income less than $15,000 would not have purchased private health insurance, if an employer had not offered and contributed to their health insurance plan.

The flatter rate structure of some major tax reform proposals would exacerbate this regressivity. Under current-law rates, the progressivity of the tax schedule offsets the effect on tax liability of the declining share of health insurance in compensation at higher income levels.

In short, whatever the criterion used for determining the cost of each employee's cost of benefits, if it targeted those individuals likely to have the highest incidence of claims, it would also target those most likely to need insurance. Since those most likely to become sick, disabled, or die would face the highest tax liability, taxing employer contributions for benefits would impose tax liability in inverse proportion to ability to pay.

Another potential effect of taxing employee benefits to the individual could be to increase the attractiveness of flexible compensation or cafeteria plans. Under flexible compensation plans, empolyees can elect various levels of coverage under the major types of employee benefit plans. An employee choosing a less-generous health insurance plan, for example, can "spend" the employer's cost savings on added life insurance, vacation days, or other benefits. All employees—except for those who chronically guessed wrong about their need for health insurance or other benefits—would segregage themselves into plans according to the expected value of their claims. While this is the fundamental principle behind flexible compensation plans, many employers sponsoring these plans now price the high-cost insurance options at less than the value of the claims expected under them to maintain a reasonable risk pool of participants under each option. If employees were being taxed on the value of employer contributions, however, such subsidies would probably have to stop, since they would mean that low-risk employees would be paying the tax bill for higher-risk persons. If all persons chose plans priced at the expected value of their claims, the risk-sharing inherent in group insurance plans would be eliminated.

Eliminating employer deductions for employee benefits

Some of these distributional problems could be avoided in major tax reform proposals that would include nonpension employee benefits in the tax base by eliminating employer tax deductions for them. The value-added tax could have this effect, depending on how it was designed, and some versions of the consumption tax would provide for this.

Faced with such a provision, employers who now offer benefits would probably cut them back and those who do not would probably not institute them. Some employers who offer benefits might eliminate them or continue to offer them with full employee payment. Others might forego improving their benefits packages, while still others might institute or increase employee contributions, deductibles, or copayments where appropriate. Employers are already working to reduce their benefit costs; including benefits in the tax base would clearly accelerate this process but at a social cost.[11]

The greatest impact of proposals to eliminate employer deductions for benefits would probably be on those employees who are not now covered. Most employees without benefit coverage tend to be in smaller firms and at lower income levels. As small and new firms grow and become profitable, they are more likely to incur the financial commitment involved in establishing employee benefit plans. Removing the tax deductions for employee benefits would probably make this commitment uneconomical.

Capping employee benefits as a share of total compensation

Another alternative that has received some attention in tax policy debates—though not necessarily in the context of major tax reform—is establishing a limit on the share of total compensation that can be provided in the form of tax-favored employee benefits. Benefits provided in excess of this amount would be subject to payroll tax, income tax, or both. Under alternative proposals, the cap could cover contributions for all benefits, or pensions, walfare benefits, and so-called "fringe" benefits could all be capped separately.

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[10] Deborah J. Chollet, *Employer-Provided Health Benefits: Coverage, Provisions and Policy Issues*, p. 100. For a discussion of taxing employer contributions to health insurance, see also "Revising the Federal Tax Treatment of Employer Contributions to Health Insurance: A Continuing Debate," EBRI *Issue Brief* no. 21, August 1983.

[11] For a discussion of employer efforts to reduce health care costs, see "Controlling the Cost of Health Care: Recent Trends in Employee Health Plan Design," EBRI *Issue Brief* No. 23, October, 1983.

Such an approach could raise its own set of problems. For example, an employer with a mature, long-tenure work force could be put at a competitive disadvantage compared with an employer with a younger work force, even if the benefits in the two firms were identical. Furthermore, a cap could act as a target that firms with less-generous benefit plans would feel compelled to meet to maintain their competitive positions. The efforts of such employers to catch up could offset the effects on employers whose benefits exceeded the cap. Such a system could also be difficult to implement for non-profit or public-sector employers, neither of which pay business profit taxes.

Of the four alternatives that tax reformers have proposed, however, only the national sales tax would offer employers and employees more flexibility thant he tax cap to choose among benefits and to choose the level of coverge to be provided under major benefits. Establishing a tax cap, however, would point up the difference in the tax treatment of insurance provided under the employer's auspices compared with the treatment of insurance purchased by the individual directly. While persons without pension coverage can establish IRAs on a tax-preferred basis, those without health or other insurance pay for such protection with after-tax dollars. A tax cap combined with provisions allowing individual purchases of insurance with before-tax dollars could mitigate the detrimental effects on expansion of coverage that could result from taxing employer contributions for benefits.

An excise tax on benefits

Rather than cappiing benefits as a share of compensation, it would be possible to impose an excise tax on all tax-favored benefits, whatever their level. This was proposed by the Treasury to this Committee in Testimony of June 1983. This would avoid creating a target benefit level for employers to reach. An excise tax, however, would have the same effect on benefits eliminating employer deductions for benefit contributions. Employers now offering benefits would cut them back, while those without benefits would probably not institute them. The only difference between the two options would be in the tax rates they would impose. If an excise tax carried lower rates than the corporate or business taxes the firm might be paying, then the incentives to eliminate benefits would not be as strong.

A value-added or national sales tax

Instituting a national sales tax or a value-added tax would not have the same effect as a tax levied specifically on benefits. Any tax levied at the point of sale or at different stages of production would be neutral between wages and benefits as a form of compensation and thus would not change employer and employee preferences.

CONCLUSIONS AND POLICY IMPLICATIONS

Basic tax reform appeals to a broad constituency. Current and projected deficit levels pose a threat to the economy; it may be that only sweeping changes in the tax structure will allow the federal government to raise adequate revenues to eliminate this threat.

The basic tax reform movement is motivated in part by the erosion of the income tax base due to the prolilferation of both business and individual tax preferences. As the Congress proceeds with these discussions, it will be confronted with representatives of almost every special interest that benefits from the 106 provisions in the code that lead to tax expenditures, and whose elimination could hurt the pocketbooks of these interest groups. One group will probably not be represented in these discussions, however. The average working person, who takes for granted the health, pension, and insurance benefits provided in his or her compensation package, almost surely does not think of employee benefits as a tax loophole.

The Congress, however, is charged with taking a perspective on these issues that transcends the concerns of special interest groups. In particular, it is essential that major tax reform debates look beyond revenue-raising considerations alone and examine the broader economic implications of eliminating incentives now built into the tax code.

Many of these incentives were designed to further social and economic goals that could not be efficiently pursued through the expenditure side of the budget. The elimination of these incentives in the name of short-term budget goals could lead to much higher costs for the federal government in the future. When compared with the costs of assuring economic security through direct federal spending, tax incentives for employee benefits may turn out to be a bargain. For example, according to Department of Commerce data, employer-based pensions now provide over half as much retirement income as the Social Security program.[12] If employer pensions were eliminated and Social Security benefits were to be increased by 50 percent, the deficit projected in the President's budget proposal would have been almost 60 percent higher. Could the economy sustain such an increase?

Tax incentives for health insurance raise similar issues. Tax expenditures attributed to the tax exemption of employer contributions to health insurance were estimated at $17.6 billion in 1984.[13] This may be a relataively low price for society to pay for a system of health insurance that may pay as much as $90 billion in benefits in 1984 and serves more than 60 percent of the population. In 1984, by comparision, federal spending for Medicare is expected to total $62.2 billion dollars; federal-state spending for Medicaid is estimated at $37.8 billion.[14] Together, these public programs finance health care services for only about 18 percent of the population.

In any revisions of the tax treatment of employee benefits, several considerations should be prominent. First—distributional impact—the middle-income worker will be the major victim of any such changes. Second, progressivity desired—some treatments would be more regressive than others. In particular, including benefit contributions in the individual's adjusted gross income is the option that would most disrupt the arrangements now used for providing benefits and could also result in the most regressive redistribution of tax liability and benefit coverage. Third—transition—would create significant reductions in public welfare and would exacerbate intergenerational tensions. Fourth—simplification—taxing benefits would actually be more complex than the current system. Finally, the potential revenue gains from taxing benefits should be compared with additional demands that could result on the expenditure side of the budget. Once such a comparison is made, the tax code could prove to be a very efficient means of encouraging private provision for individual economic security.

EBRI RESEARCH RELATED TO MAJOR TAX REFORM

Books

Deborah J. Chollet, "Employer-Provided Health Benefits: Coverage, Provisions, and Policy Issues" (Washington, D.C.: Employee Benefit Research Institute, 1984)

Sophie M. Korczyk, "Retirement Security and Tax Policy" (Washington, D.C.: EBRI, forthcoming), Chapter IV.

Dallas L. Salisbury, ed., "Why Tax Employee Benefits?" (Washington, D.D.: EBRI, 1984)

Shorter Papers

"Basic Tax Reform: Implications for Employee Benefits," EBRI Issue Brief No. 28, March, 1984.

"Revising the Federal Tax Treatment of Employer Contributions to Health Insurance: A Continuing Debate," EBRI Issue Brief No. 21, August, 1983.

"Controlling the Cost of Health Care: Recent Trends in Employee Health Plan Design," EBRI Issue Brief No. 23, October, 1983.

Deborah J. Chollet, "Assuring Economic Security for Workers: Health, Disability, and Life Insurance Benefits," Statement before the United States Senate finance Committee, Subcommittee on Taxation and Debt Management, Hearing on Employee Fringe Benefits, July 26, 27, and 30, 1984.

APPENDIX I

For legislative policy assessment purposes benefits can be classified into at least nine categories: (1) Legally required benefits (including employer contributions to Social Security, Medicare, unemployment insurance and workers' compensation insurance); (2) discretionary benefits that are fully taxable (primarily, payment for time not worked); (3) discretionary benefits that insure the employee against financial risks and are tax exempt (including employer contributions to health, life, and disability insurance plans); (4) discretionary benefits that help the employee meet special needs and are tax exempt (including employer contributions to child care and legal plans); (5) discretionary benefits that have traditionally been called fringes and are intended to meet employer needs and are tax exempt (including employer provision of purchase discounts, job site cafeterias, special bonuses and awards, van pools, clubs, and parking); (6) discretion "reimbursement account" benefit programs that have been legally allowed since 1978 which allow employees to have reimbursement accounts—funded by the employer or through salary reduction—to pay expenses that fall into "statutory benefit" areas and are tax exempt (including health care reimbursement, child care reimbursement, etc.); (7) discretionary benefits that provide retirement income as a stream of payments and for which taxes are deferred until benefits are received (including employer contributions to defined benefit pension plans and to defined contribution plans which require payment in the form of an annuity); (8) discretionary benefits that provide for the deferral of salary until termination of employment, generally pay benefits as a lump sum, and for which taxes are deferred until benefits are received (including contributions to some profit sharing plans, to money purchase plans and ESOPs); and (9) discretionary benefits that provide for the deferral of salary until special needs arise (loans and hardship), or until termination of employment, generally pay benefits as a lump sum, and for which taxes are deferred until benefits are received (including contributions to some profit sharing plans, thrift-savings plans, and salary reduction plans).

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[12] In 1981, the latest year for which complete data are available, Social Security Old Age, Survivors', and Disability benefits were $138.6 billion, while private-sector and federal, state, and local government retirement plan benefits were $73.2 billion.

[13] Budget of the U.S. Government, Fiscal Year 1985, Special Analysis G.

[14] Deborah J. Chollet, "Assuring Economic Security for Workers: Health, Disability, and Life Insurance Benefits," Statement before the United States Senate Finance Committee, Subcommittee on Taxation and Debt Management, Hearing on Fringe Benefits, July 26, 27, and 30, 1984.

During a time when there are no apparent limits on direct federal expenditures, or on "tax incentives," analysis may not need to focus on the diversity of employee benefits. During a time of apparent limitations, however, when priorities must be decided upon, careful analysis is required of each employee benefit: why each employee benefit exists.[1]

Statement of the Federal Party of the United States

Ladies and gentlemen of the committee, I wish it were possible to present to you in person the program of the Federal Party of the United States for abolishing the deficit, but time and circumstances do not permit to do this in person.

However, you are well aware that you have received messages from us on the methodology to be used in getting rid of this deficit. The first benefit from monetizing the bonds as we have communicated to you before is that prime interest could be materially reduced to a possible low of 2½ per cent. Also, the $1.6 trillion which would be generated by the conversion of bonds to specie would make it possible for the steel industry to afford to be able to rebuild and compete with foreign steel, thus preventing the eventual total destruction of the Steel Workers' Union.

We have told you before that we are not proposing the abrogation of government bonds. Each bond will be counted for its original cost, plus earnings to date. Thus, the bondholder will not be cheated of any of his assets. The only change which will occur will be that the bondholder will have to go to the private sector to find someone to borrow his money for an equitable interest. This will cause the cost of capital to fall to that point which will enable the private sector to function well without being strangled with high capital costs.

Your list of experts who will testify before you on Tuesday and Wednesday and Thursday of the week of the 23rd is quite impressive. However, the Federal Party feels that it will all amount to a "dance around the mullberry bush".

The essence of the problem is we cannot go on paying $180 billion, plus 12 per cent more every year, per year, without destroying our private sector. The Federal Party contends that for Congress to pay interest on its own currency is in itself an unconstitutional arrangement.

The Federal Party demands that all interest-bearing obligations of the United States government be converted at once to the values to which they have accrued. It will not be necessary to print new currency because each bondholder can be given credit for the amount of notes and accumulation that he holds. This credit can be passed on to his borrowers who will be from the private sector, and not from the government.

The effect of this would be that the government would within 8 to 12 months not only be running in the black, but would have a large surplus from the increased taxes collected from our reactivated economy. This is the only honest and intelligent approach, and the Federal Party hopes that before our system crashes, such remedial actions will be taken. They are the only effective ones.

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[1] Taken from a statement on Employee Benefits and Economic Security by Dallas L. Salisbury before the United States Senate Finance Committee Subcommittee on Taxation and Debt Management hearing on Employee Fringe Benefits, July 26, 27, and 30, 1984.

The Federal Party thanks you again for your kind invitation to present its views.

STATEMENT OF JIM JONES, MANAGING DIRECTOR, GOVERNMENT RESEARCH AND DEVELOPMENT FOUNDATION

The Federal income tax system is a government function that has incestuously bred into itself an innate sense of pessimism for the average taxpayer. Everywhere one discusses the subject, the eternal expletive is "something has got to be done." Well, our Congress every year does do something. It increases the complexity—it decreases the base by granting continuing special interest deductions, exclusions and preferences. In so doing there is a concomitant increase in the fairness gap between different taxpayer groups.

In the past the Congress has attempted to address each new measure of inequity by passing still more legislative patches (amendments) whch are supposed to remedy the situation—according to the special interest which claimed that particular inequity. Now 70 years and 8,000 pages of fine print later, the Net Income Tax (NIT) System has reached intolerable levels of administrative inefficiency; erosion of the tax base until the system can no longer support the government; vast decreases in the neutrality of the system; increased public attitudes of distrust, and a more determined effort by special interest lobbyists to make the tax law more favorably disposed toward them and at the expense of other taxpayers.

Recognition by many that this is true has been evidenced by the bringing forth of the Gross Income Tax (GIT) in 1975; the "Cash Flow" or "Consumption" Tax in 1977; the Hall-Rabushka Tax in 1979; the Value Added Tax (VAT) in 1980 and a frenzy of "Flat Rate" proposals in 1982-83-84.

Of all the proposals which have the revenue-raising capability to replace the Net Income Tax (NIT) System, none except the Gross Income Tax (GIT) or the National Sales Tax (NST) address the fundamental problem of the base to which the rate (flat or otherwise) would apply. The fundamental problem is that our tax system is based on net income. When a taxpaying business entity figures its taxable income it contorts in every conceivable fashion to reduce its net income for tax purposes while at the same time increasing its net income for purposes of pure economic gain. This tug of war between the desire for low taxable income and high economic income has produced our present anarchic tax system.

In many cases, especially for large corporations, economic sources of income have been replaced by tax sources of income.

People have been saying for years that "there must be a better way." There is a better way and that is the single rate business oriented Gross Income Tax or simply the GIT System. The GIT System would go to the basic source of all tax funds and that source is the business activity of the nation. Business activity is defined as the issuance of invoices or bills to a buyer and the payment of those invoices or bills to the vendor. These payments are the Gross Receipts of the vendor. That vendor's Gross Income is the Gross Receipts less the Cost of Goods sold. The GIT System would tax directly this Gross Income at a single rate which is estimated to be between 4% and 6%.

For the individual wage earner (IWE) there could be two ways of applying GIT. One way would be to use the principal of allocation, see line 33 of the illustrative gross Income Tax Return (Exhibit 1). This would eliminate the filing of over 97 million form 1040 tax returns. The April 15 national trauma would no longer exist.

The other way would be to have IWE's file a return and pay the GIT rate similar to business returns. This would reduce the GIT rate by approximately 1%.

To those critics who say that GIT would cost many jobs of CPA's, tax preparers and tax lawyers, let them be reminded that GIT is a new technology. New technologies in the past—the machine age; the industrial revolution; the computer age—did not cost jobs. They only shifted emphasis on the way those jobs were being accomplished. Displacements were only temporary and many new types of jobs were created.

One of the reasons we need this new tax technology is that we are rapidly approaching an economic feudal state. In the middle ages the feudal fiefdoms were enforced by standing armies. Today's feudal fiefdoms are being enforced by economic power gained from our tax system. The GIT system would foster a return to a large middle class which has been the traditional strength of America.

There are a number of advantages to the GIT System.

For the wage earner

1. No more filing of Form 1040.

2. Rates would be so low that special deductions like mortgage interest deductions would not be necessary.

3. No more fear of audits by the IRS.

4. Paying taxes would again become a source of pride instead of dread and disgust.

For the businesses of our country

1. At least 90% of paperwork (dollars) now required for tax compliance would be eliminated. Business paperwork costs have been estimated at over $100 billion per year.

2. Business tax audits would be simple, direct and consume very little time.

For the government

1. Cash flow would no longer be a problem and the government could cease most of its borrowing activities.

2. At least 70% of the government's compliance and collection costs would be eliminated.

3. The GIT system is so powerful as a revenue producer it could reduce our national debt in a short period with only a slight increase in the GIT rate.

An eclectic view of all the tax "reform" proposals put forth in the past few years should be profitable. A question and answer format would be most informative. In this format, the following listed abbreviations are used:

A. GIT—The Gross Income Tax
B. FRT—The Flat Rate Tax (Bradley/Gephardt; Kemp/Kasten; Quayle; Siljander; Hall/Rabushka; etc.)
C. VAT—The Value Added Tax
D. NST—The National Sales Tax
E. DET—The Dedicated Excise Tax
F. NIT—The Net Income Tax
G. UCT—The Uniform Consumption Tax (Based on Blueprints for Basic Tax Reform, Chapter 4)

Question 1. How complex is the system?

Answer:

A. GIT—The GIT is extremely easy to administer for both the taxpayer and the government. Computerization is an easily accomplished method of keeping tax books. Yearly tax bookkeeping is no longer a traumatic experience. (See Exhibit V).

B. FRT—The Flat Rate Taxes so far proposed such as Bradley/Gephardt, Kemp/Kasten, Quayle, Siljander, and DeConcini, still have their roots in our present NIT system. Even though some simplification may be possible for a short time, it stands to reason, based on historical evidence, that they will all be amended to again resemble our present state of tax stagnation after a few Congresses have met.

C. VAT—This is a complex tax that would require much record-keeping to determine the "value added." It is also a point-of-sale type of tax that would require a larger IRS.

D. NST—This is a complex tax that would increase the size of the IRS because of the extra personnel required to audit the point-of-sale collection procedure. Complexity would also be increased because of the exemptions that would inherently accrue for items such as living necessities or business exemptions.

E. DET—This tax could be easily collected and in fact is accomplished by the use of stamps (cigarettes, liquor) and through collection by vendors, such as the gasoline tax.

F. NIT—This tax has a wealth of current empirical evidence that the system is so complicated as to preclude its further use as a practical vehicle for funding the government.

G. UCT—The UCT is simply another variant of NIT and of course just as complicated.

Question 2. How fair and equitable is the system?

Answer:

A. GIT—The GIT is fair because it collects the tax directly from the source of all taxes—the business activity of the country. There would be fewer entities involved in the collection process, hence opportunities for unfair treatment would diminish.

B. FRT—The "flat rate" taxes share the same unfairness considerations as our present NIT system.

C. VAT—The VAT would appear to be fair if it is conceded that there be no objections to its regressive nature.

D. NST—The NST has always carried with it the historical criticism that it is regressive. However, state sales taxes have never had taxpayer resistance that property taxes and net income taxes have had. Probably the reason for this is that rates are relatively low when compared to other tax systems.

E. DET—The DET is fair in the sense that only the receiver of government services pay the tax. It's a one-on-one relationship.

F. NIT—The NIT is unfair and the unfairness has its roots in the very way the tax is structured. Assume that all companies in the country were rolled into just two large conglomerates, one of them made good acquisitions and had good management with good net profits every year, while the other was poorly managed and made very little net profits each year. The government now comes along and says, "Hey folks, we need $900 billion to operate on next year." It is self evident that the profitable well-managed conglomerate is going to carry the tax load for the poorly managed conglomerate. This subsidization of poorly managed businesses by well-managed businesses is an everyday occurrence in thousands of businesses on a smaller scale. It's the fundamental and monumental flaw of our NIT system.

G. UCT—The UCT simply further narrows the tax base. The short fall must be made up by other taxpayers and is thus unfair. Another extremely unfair characteristic of the UCT is its regressiveness. A taxpayer who makes $50,000 per year with a $10,000 per year consumable expense has $40,000 left to save or invest tax free. A taxpayer who makes $500,000 per year with the same $10,000 consumable expense has $490,000 to save or invest tax free.

Question 3. How economically neutral is the system?

A. GIT—The GIT is almost 100% neutral if no credits were allowed. If more below-the-line credits are legislated into GIT as the years pass, it becomes less neutral. However, credits cover a broader public purpose than above-the-line deductions, which are highly subjective and usually for special interest purposes. Credits also are more easily accounted for in our computerized society.

B. FRT—The FRT has essentially the same neutrality characteristics as our present NIT system because the basis for the FRT is the same as NIT.

C. VAT—The VAT does not have many neutrality questions associated with it. It is primarily a revenue-producer, and for the Congress to use it to change economic or social behavior would necessitate extraordinary legislative handsprings.

D. NST—The same comments cover the NST as stated under VAT above.

E. DET—The DET is one of the most non-neutral systems of all. Indeed, it is used many times as a punitive tax, i.e., tobacco and liquor taxes.

F. NIT—The NIT is a non-neutral as the DET. However, the effect is more massive and with little control; witness the explosion of abusive tax shelters in the past few years.

G. UCT—The UCT is essentially the same as the NIT in its non-neutrality with the additional provision that income that is invested or saved would not be taxed. This feature would open the door for a new era of money hording similar to that in the late 1920s and early 1930s.

Question. 4. What is the base of the tax?

Answer:

A. GIT—The base of the GIT is the business activity of the country. The source of all taxes is the paid invoices of the country's business operating entities (BOEs), both incorporated and unincorporated. The GIT has the broadest base of all the major tax systems.

B. FRT—The Flat Rate Tax systems so far legislatively proposed have the NIT system as their respective bases.

C. VAT—The VAT has as its base the value added to goods manufactured at each stage of production. Labor costs would be indirectly factored in through sales pricing. The VAT tax collection would stop at the wholesale level, unless VAT legislation would specifically included sales markups in a retail operation as "value added." Basically the VAT is a tax on the GNP.

D. NST—The base of the NST would be the retail sales of the country. Traditionaly, state sales taxes are not collected on wholesale transactions.

E. DET—The base of the DET is a selected commodity or group of commodities, usually for specific user purposes.

F. NIT—The base of NIT is the net income of the BOEs, less any paper deductions, i.e., depreciation deductions. It has the narrowest beginning base of all the major tax systems except the UCT.

G. UCT—The UCT has its base in the NIT except, that it does not tax that part of income that is not spent which narrows the base even more.

Question 5. Can the tax system completely replace the present NIT system or will it be an additional new tax system?

Answer:

A. GIT—The GIT can replace the present NIT system in its entirety. It can also replace the present social security payroll tax system with about a 4% increase in the GIT rate. If GIT were to be used to replace both the NIT and the payroll tax the rate would be from 7% to 9%.

B. FRT—The FRT in one of its variations can of course not ever replace our present NIT system because they are derivatives of that system. To raise sufficient revenue, a supplementary tax like a VAT or a NST would have to be legislated.

C. VAT—The VAT cannot replace our present NIT system because it is narrowly based on the GNP. It would have to be a new "helper" tax in addition to our present tax system.

D. NST—The NST has the revenue-raising capability to replace the NIT, if it is properly implemented.

E. DET—The DET cannot replace NIT but could be enhanced by the addition of more commodities or services. The ultimate in addition could approach the NST with special treatment of certain commodities.

F. UCT—The UCT cannot replace the NIT because it is a derivative of NIT. In fact UCT, is a further narrowing of the base on a grand scale.

Question 6. How effectively does the tax system enable Congress to use tax expenditures for broad public purposes?

Answer:

A. GIT—The GIT does not allow for any type of deductions or exclusions above-the-line. However, it does allow below-the-line credits. The major difference between the two types of expenditures are that deductions are subjective with a particular taxpayer, while credits cover a wider spetrum of classes of taxpayers. Credits have a strong kinship with direct grants. The Congress has better control of tax expenditures under GIT because of the open nature of such expenditures when credits are used.

B. FRT—The FRT is based on NIT. NIT has been used for the last 70 years for all kinds of incentives (or disincentives) for both social and economical action. The bulk of that activity has occurred since the early sixties. The results are self-evident. The FRT is but another variation of the NIT.

C. VAT—The VAT would be very difficult for the Congress to use for tax expenditures on any major scale. However, it could be used to affect certain industries, e.g., lower rates could favor the steel industry. Such usage could result in an administrative maze as the years pass.

D. NST—Much the same comments concerning the VAT are applicable to the NST.

E. DET—The DET taxes that now exist have a highly selective use for social and economic effects, to relate them with respect to tax expenditures would entail their broad expansion until they would approach the NST as a tax force.

F. NIT—The uses and effects of using the NIT for tax expenditures are historically self-evident. One of the all-encompassing tax expenditures is the allowance of above-the-line business deductions.

G. UCT—The UCT is but yet another variation of the NIT. Its big tax expenditure is the exclusion from taxable income that part of income that is not spent on consumables.

Question 7. How easy would it be for the taxpayer to comply with the tax and what would expected public attitudes be?

Answer:

A. GIT—The GIT would eliminate much public (especially wage earners) contact with the paying process, but who would have complete knowledge of their contribution to the governments expenditures. This is accomplished by the allocation process, see Exhibit 1, Illustrative GIT Tax Return, line 32. For businesses the GIT would be much simpler to file and would eliminate the W2 form and its attendant headaches. Also, businesses that are computerized could deposit their tax liability on a daily (or other short term) basis and thereby discharge their tax responsibilities immediately. This would eliminate the expensive (and unproductive) year end trauma of tax return preparation.

B. FRT—The FRT is again another variation of NIT and will carry all of the negatives of the present tax system.

C.—VAT—It would not be hard for the wage earner to comply because he or she would be in the process only to the extent of paying the tax in the commodity pricing process. The sellers would be saddled with an additional bookkeeping chore as well as their State sales tax chores.

D. NST—Much the same comments concerning the VAT apply to the NST.

E. DET—Most excise taxes today are collected via the stamp (cigarettes, liquor) or are included in the sales (gasoline) price. Even when they are punitive, there seems to be little public outcry.

F. NIT—Our present tax system has an extremely poor public image. Sometime even violent behavior is exhibited. The Federal income tax has surpassed the property tax as the most unpopular tax.

G. UCT—The UCT, as a variation of the present NIT, would probably be very unpopular because the public would regard it as the "rich man's" loophole.

Question 8. Would the tax system allow an invasion of privacy?

Answer:

A. GIT—The GIT would have a minimal privacy impact for businesses because the tax would be almost entirely cash-oriented. Peripheral issues such as entertainment expense or travel expense would no longer exist. For wage earners, the privacy issue would also be minimal to the extent that the Congress refrains from using the allocation process for social purposes.

B. FRT—This variation of the NIT would have the same privacy problems as our present NIT system.

C. VAT—There would appear to be no privacy problems with the VAT.

D. NST—The same comments apply.

E. DET—The DET exhibits no problems of privacy.

F. NIT—Our present NIT system has large problems of privacy invasion. For wage earners, the tax returns and subsequent audits reveal, many times in detail, the lifestyle and personal work details that under normal circumstances would be private matters. For businesses the privacy issue is minimal for large companies but increases as the company size decreases. Small proprietorships are but a small step removed from the wage-earner concept.

G. UCT—This variation of the NIT has the same privacy problems as the NIT.

Question 9. Under the tax system what is the government's ability to effect collections and to audit accounts?

Answer:

A. GIT—Collections under the GIT would be made by the BOE directly from the source—the business activity of the country. Transmittal of the funds could be simply made by electronic or manual transfer on any periodic basis from 1 day to 1 year or any period in between. Audits would be made simple by examining bank accounts and the few papers that would account for tax credits. Long, drawn-out audits would no longer be necessary.

B. FRT—Collection and audit procedures under FRT would be the same as NIT.

C. VAT—The VAT does not have the revenue-producing ability to replace the NIT. Therefore, additional collection and enforcement would have to be added to the IRS. The number of personnel added could be large because of the point-of-sale nature of the tax system.

D. NST—The NST has the revenue-producing capability to replace the NIT. If it did, our tax collections and enforcement mechanism would be changed drastically. There should be relatively few problems for the Government.

E. DET—The DET would have few problems in collection and enforcement. The government has current experience in this area.

F. NIT—The ability of the government to enforce and collect taxes is historically documented.

G. UCT—This variation of the NIT would introduce new measures for collection and enforcement by having to monitor millions of savings and investment transactions as well as having millions of borrowing/lending transactions.

Question 10. Would the tax system be progressive or regressive?

Answer:

A. GIT—The question of progressivity or regressivity under the GIT is Moot because the tax is collected by the Nation's businesses directly from the source (business activity) and is then transmitted directly to the government.

B. FRT—The same problems of progressivity or regressivity exist under FRT as under NIT. Progressivity does increase as loopholes are closed and some of the FRT proposals incorporate some loophole closing.

C. VAT—The VAT would be regressive because the VAT would be factored into the final consumer price. Since a higher percentage of lower income taxpayers spend money on consumable goods, the tax burden falls on them more heavily.

D. NST—The NST, like all sales taxes, are recognized as being regressive.

E. DET—The DET is a broad-based use tax that cuts across all income classes and is not usually considered regressive.

F. NIT—The NIT is highly regressive. This regressivity decreases almost linearly with an increase in taxpayer income. Actual degree of linearity depends on a taxpayer's investment program.

G. UCT—The same problems with respect to regressivity under UCT are the same as exists under NIT.

Question 11. How well does the tax system relate to or track the economy?

Answer.

A. GIT—The GIT tracks the economy in an almost one-to-one relationship. If the Nation's business activity increases 1% and the GIT tax rate is 5%, then the increase in tax revenue is 0.05%. The degree of aberration from this would be the aggregate amount of tax credits being extracted from the economy.

B. FRT—Because the FRT is a derivative of the NIT, there is only an amorphous relationship between the economy and the tax revenue.

C. VAT—The VAT would have a relatively good relationship with the economy. The degree of aberration would depend on current ratios of the production of goods to the production of services.

D. NST—The NST would track the economy very well depending on how many exemptions or exclusions were allowed.

E. DET—The DET would hardly track the economy at all, the reason being the relatively small percentage of excise tax sales to total sales.

F. NIT—Because the empirical evidence is abundant with respect to our current tax system, it is evident that NIT does not track the economy except in an amorphous way.

G. UCT—The same problems with tracking the economy under UCT are the same as exist under NIT.

Question 12. Which tax system would allow the easiest transition?

Answer.

A. GIT—The GIT tax return would be simple and easy to prepare for businesses. It is estimated that only 10% of the paperwork required for NIT would be required for GIT; for wage earners 100% of the paperwork would be eliminated under the allocation process. With this vast diminution of preparation costs, it would be practical to run parallel systems for a specified period, say 5 years (Exhibit II).

B. FRT—Since the FRT is a variant of NIT, there is no transition problem. Transition simply resolves itself into the traditional amendment processes that have been enacted to change the 1954 Code ever since that Code became public law.

C. VAT—There are no transition problems with the VAT because it does not have the capability to replace the NIT system. There would be problems of staffing and organizing a new function for the IRS.

D. NST—There would be no transition problems if NST were conceived as a tax supplementary to the present NIT. Similarly to VAT, there would be staffing and organization problems for an additional function of the IRS.

E. DET—Because the DET would not have the capability of replacing NIT, there are no transition problems. There would be problems of upgrading and increasing the scope of present IRS activity.

F. NIT—Transition problems are not applicable.

G. UCT—Because the UCT is a variant of NIT, there are no transition problems. The problems would be the traditional amendment problems in changing the 1954 Code.

Question 13. What would be the paperwork taxpayer impact and the consequent implicit taxation?

Answer.

A. GIT—Paperwork for businesses would be cut by an estimated 90%, thereby cutting the present implicit taxation by a proportional amount.

B. FRT—Paperwork and implicit taxation would remain about the same as now because the FRT is a NIT derivative.

C. VAT—There would be an increase in implicit taxation under the VAT, perhaps as much as 25%.

D. NST—There would be an increase in implicit taxation under the NST if NST were not conceived as a replacement for NIT. If it were legislated to replace NIT, there would be a diminution of paperwork and implicit taxation.

E. DET—There would be an increase in paperwork in direct proportion to the commodities added to the excise tax base.

F. NIT—The paperwork and implicit taxation of the NIT has increased steadily since 1913. There was an explosion of paperwork requirements, starting in the mid-sixities, which has continued until the present, culminating with the Deficit Reduction Act, PL 98-369. Thus, it is reasonable to assume that this implicit taxation will continue as long as the NIT is retained.

G. UCT—The same remarks apply to the UCT as apply to the NIT above.

Question 14. What would be the administrative efficiency of the tax system for both the taxpayer and the government?

Answer.

A. GIT—For the government, administrative efficiency should increase on the order of 70%. An OMB report in 1976 noted that of all paperwork generated by the government, 76% was generated by the Federal tax collection mechanism. Since that time, other reports have given figures down to 54% for tax paperwork. Prima facie evidence suggests a decrease in administrative efficiency with passage of the ERTA, TEFRA, and Deficit Reduction Acts since 1976. If the allocation process is used, the paperwork for the wage earner should decrease by at least 98%.

B. FRT—Because the FRT has its basis in NIT, which is in turn based on the 1954 Code, there is no reasonable cause to believe that there will be any increase in administrative efficiency for either the government or the taxpayer. The continuing result will be burgeoning electronic file drawers (EDP) to match up billions of pieces of paper.

C. VAT—Administrative efficiency of the VAT for the government would be quite low because of the subjective nature of the tax. Audit procedures would be extensive and involved. Administrative efficiency for the taxpayer could be relatively simple depending on how the "value added" is calculated and what components of selling prices are allowed.

D. NST—The same remarks applying to the VAT would apply to the NST.

E. DET—The administrative efficiency of the DET has been basically established. With increased DET activity, refinements may be necessary because of sheer volume.

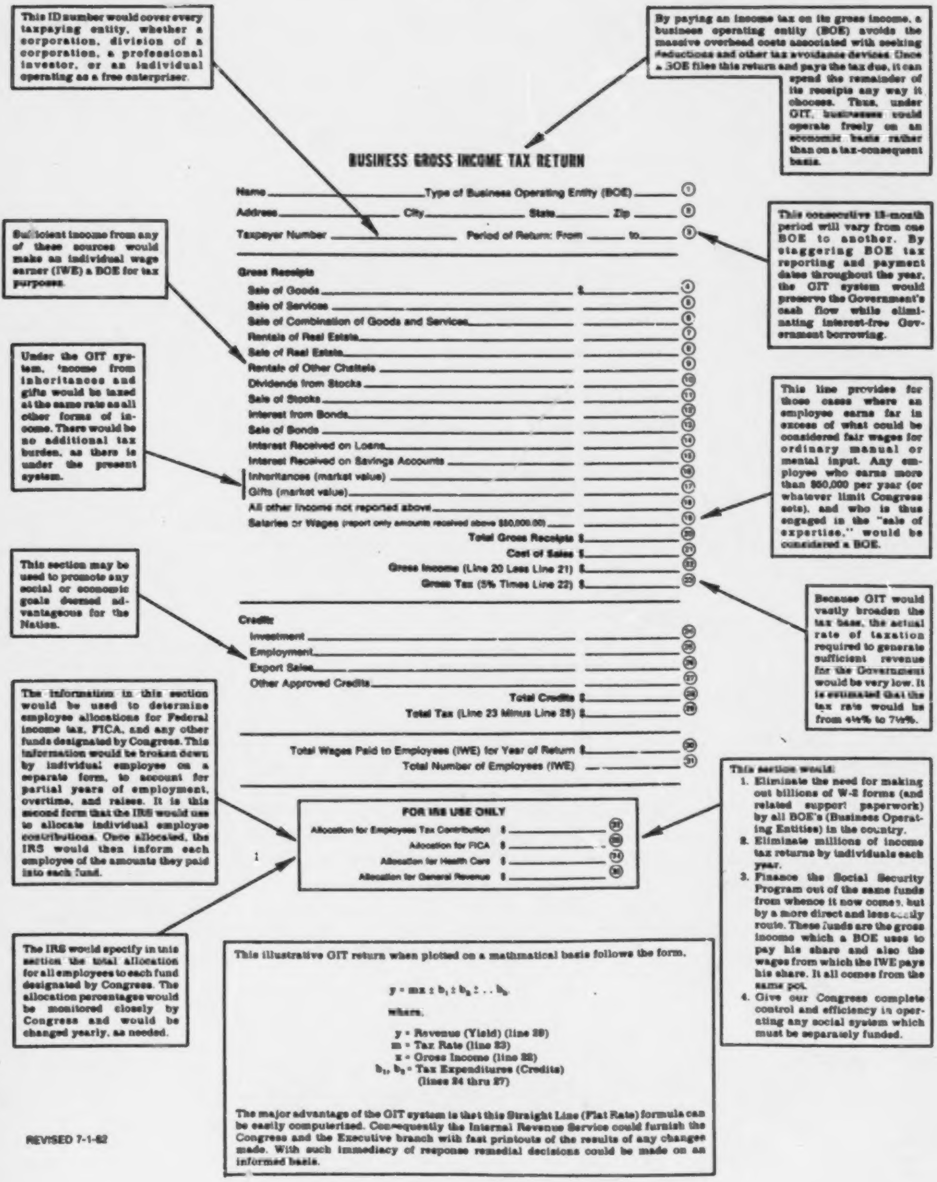
F. NIT—Administrative efficiency of the NIT has been established. Further expansion of NIT requirements with each passing Congress suggests that administrative efficiency will further decrease.

G. UCT—The same remarks for the FRT would essentially apply to the UCT.

In conclusion it would seem that everyone who is studying our present tax and budget dilemma would examine such questions as stated above in great detail and not resort to rhetorical presentations about theoretical "distortions," "economic pressures," etc.

Now is the time for the nation to return to normal entrepreneurship on an economic basis. Let the tax system do its job, and that is to raise revenue.

EXHIBIT I



BUSINESS GROSS INCOME TAX RETURN

Name ______ Type of Business Operating Entity (BOE) ______ ①
Address ______ City ______ State ______ Zip ______ ②
Taxpayer Number ______ Period of Return: From ______ to ______ ③

Gross Receipts

Sale of Goods ______ $ ______ ④
Sale of Services ______ ______ ⑤
Sale of Combination of Goods and Services ______ ______ ⑥
Rentals of Real Estate ______ ______ ⑦
Sale of Real Estate ______ ______ ⑧
Rentals of Other Chattels ______ ______ ⑨
Dividends from Stocks ______ ______ ⑩
Sale of Stocks ______ ______ ⑪
Interest from Bonds ______ ______ ⑫
Sale of Bonds ______ ______ ⑬
Interest Received on Loans ______ ______ ⑭
Interest Received on Savings Accounts ______ ______ ⑮
Inheritances (market value) ______ ______ ⑯
Gifts (market value) ______ ______ ⑰
All other Income not reported above ______ ______ ⑱
Salaries or Wages (report only amounts received above $50,000.00) ______ ______ ⑲
Total Gross Receipts $ ______ ⑳
Cost of Sales $ ______ ㉑
Gross Income (Line 20 Less Line 21) $ ______ ㉒
Gross Tax (5% Times Line 22) $ ______ ㉓

Credits

Investment ______ ______ ㉔
Employment ______ ______ ㉕
Export Sales ______ ______ ㉖
Other Approved Credits ______ ______ ㉗
Total Credits $ ______ ㉘
Total Tax (Line 23 Minus Line 28) $ ______ ㉙

Total Wages Paid to Employees (IWE) for Year of Return $ ______ ㉚
Total Number of Employees (IWE) ______ ㉛

FOR IRS USE ONLY

Allocation for Employees Tax Contribution $ ______ ㉜
Allocation for FICA $ ______ ㉝
Allocation for Health Care $ ______ ㉞
Allocation for General Revenue $ ______ ㉟

This ID number would cover every taxpaying entity, whether a corporation, division of a corporation, a professional investor, or an individual operating as a free enterpriser.

By paying an income tax on its gross income, a business operating entity (BOE) avoids the massive overhead costs associated with seeking deductions and other tax avoidance devices. Once a BOE files this return and pays the tax due, it can spend the remainder of its receipts any way it chooses. Thus, under GIT, businesses would operate freely on an economic basis rather than on a tax-consequent basis.

Sufficient income from any of these sources would make an individual wage earner (IWE) a BOE for tax purposes.

This consecutive 12-month period will vary from one BOE to another. By staggering BOE tax reporting and payment dates throughout the year, the GIT system would preserve the Government's cash flow while eliminating interest-free Government borrowing.

Under the GIT system, income from inheritances and gifts would be taxed at the same rate as all other forms of income. There would be no additional tax burden, as there is under the present system.

This line provides for those cases where an employee earns far in excess of what could be considered fair wages for ordinary manual or mental input. Any employee who earns more than $50,000 per year (or whatever limit Congress sets), and who is thus engaged in the "sale of expertise," would be considered a BOE.

This section may be used to promote any social or economic goals deemed advantageous for the Nation.

Because GIT would vastly broaden the tax base, the actual rate of taxation required to generate sufficient revenue for the Government would be very low. It is estimated that the tax rate would be from 4½% to 7½%.

The information in this section would be used to determine employee allocations for Federal income tax, FICA, and any other funds designated by Congress. This information would be broken down by individual employee on a separate form, to account for partial years of employment, overtime, and raises. It is this second form that the IRS would use to allocate individual employee contributions. Once allocated, the IRS would then inform each employee of the amounts they paid into each fund.

This section would:

1. Eliminate the need for making out billions of W-2 forms (and related support paperwork) by all BOE's (Business Operating Entities) in the country.
2. Eliminate millions of income tax returns by individuals each year.
3. Finance the Social Security Program out of the same funds from whence it now comes, but by a more direct and less costly route. These funds are the gross income which a BOE uses to pay his share and also the wages from which the IWE pays his share. It all comes from the same pot.
4. Give our Congress complete control and efficiency in operating any social system which must be separately funded.

1

The IRS would specify in this section the total allocation for all employees to each fund designated by Congress. The allocation percentages would be monitored closely by Congress and would be changed yearly, as needed.

This illustrative GIT return when plotted on a mathmatical basis follows the form.

$$y = mx \pm b_1 \pm b_2 \pm \ldots b_n$$

where,

y = Revenue (Yield) (line 29)
m = Tax Rate (line 23)
x = Gross Income (line 22)
b_1, b_2 = Tax Expenditures (Credits) (lines 24 thru 27)

The major advantage of the GIT system is that this Straight Line (Flat Rate) formula can be easily computerized. Consequently the Internal Revenue Service could furnish the Congress and the Executive branch with fast printouts of the results of any changes made. With such immediacy of response remedial decisions could be made on an informed basis.

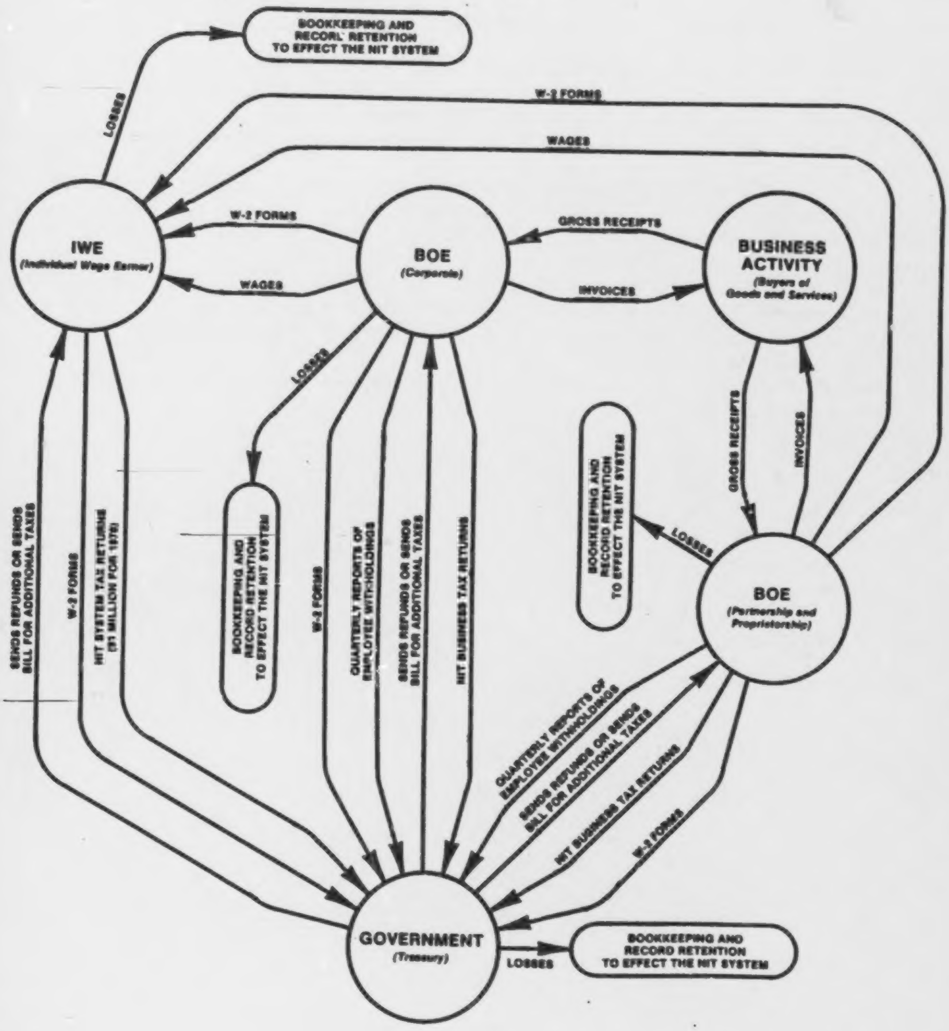
REVISED 7-1-82

[EXHIBIT II]

TRANSITION PROCESS FROM THE NET INCOME TAX (NIT) SYSTEM TO THE GROSS INCOME TAX (GIT) SYSTEM BY USING PARALLEL SYSTEMS

1. Legislate the gross income tax (GIT) system.
2. Let the legislation indicate the starting dates, to be either the next calendar year or the next fiscal year, as elected by the taxpayer.
3. On the starting date the taxpayer will file two returns: (A) a GIT return and (B) a NIT return.
4. Let the legislation indicate a beginning GIT rate of 1%.
5. After the first year let the GIT rate increase by 1% for each succeeding year.
6. Let the legislation provide for a credit to the NIT return in an amount exactly equal to the liability under the GIT return.
7. For each succeeding year repeat the process until the GIT revenue equals the NIT revenue before the GIT credit to the NIT return is applied.
8. Let the legislation indicate that any established business may elect to go to 100% GIT tax filing at any time.
9. Let the legislation indicate that all new businesses whether incorporated or not must file by the GIT method.

EXHIBIT III

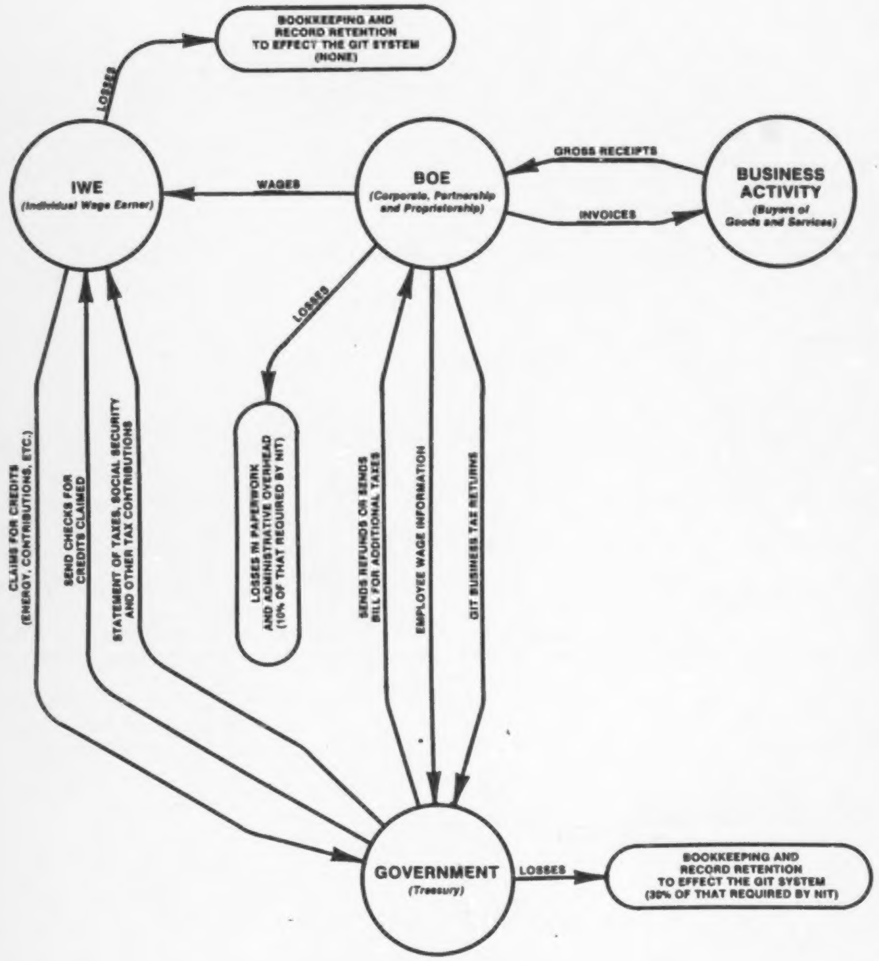

BOOKKEEPING AND RECORD RETENTION TO EFFECT THE NIT SYSTEM
LOSSES
W-2 FORMS
WAGES
IWE
(Individual Wage Earner)
W-2 FORMS
WAGES
BOE
(Corporate)
GROSS RECEIPTS
INVOICES
BUSINESS ACTIVITY
(Buyers of Goods and Services)
LOSSES
BOOKKEEPING AND RECORD RETENTION TO EFFECT THE NIT SYSTEM
GROSS RECEIPTS
INVOICES
BOOKKEEPING AND RECORD RETENTION TO EFFECT THE NIT SYSTEM
LOSSES
SENDS REFUNDS OR SENDS BILL FOR ADDITIONAL TAXES
W-2 FORMS
NIT SYSTEM TAX RETURNS ($1 MILLION FOR 1978)
W-2 FORMS
QUARTERLY REPORTS OF EMPLOYEE WITHHOLDINGS
SENDS REFUNDS OR SENDS BILL FOR ADDITIONAL TAXES
NIT BUSINESS TAX RETURNS
BOE
(Partnership and Proprietorship)
QUARTERLY REPORTS OF EMPLOYEE WITHHOLDINGS
SENDS REFUNDS OR SENDS BILL FOR ADDITIONAL TAXES
NIT BUSINESS TAX RETURNS
W-2 FORMS
GOVERNMENT
(Treasury)
LOSSES
BOOKKEEPING AND RECORD RETENTION TO EFFECT THE NIT SYSTEM

NIT SYSTEM
ADMINISTRATIVE WORK FLOW

Revised 6-1-81

Figure A

EXHIBIT IV


BOOKKEEPING AND
RECORD RETENTION
TO EFFECT THE GIT SYSTEM
(NONE)
LOSSES
IWE
(Individual Wage Earner)
WAGES
BOE
(Corporate, Partnership and Proprietorship)
GROSS RECEIPTS
INVOICES
BUSINESS ACTIVITY
(Buyers of Goods and Services)
LOSSES
CLAIMS FOR CREDITS
(ENERGY, CONTRIBUTIONS, ETC.)
SEND CHECKS FOR
CREDITS CLAIMED
STATEMENT OF TAXES, SOCIAL SECURITY
AND OTHER TAX CONTRIBUTIONS
LOSSES IN PAPERWORK
AND ADMINISTRATIVE OVERHEAD
(10% OF THAT REQUIRED BY NIT)
SENDS REFUNDS OR SENDS
BILL FOR ADDITIONAL TAXES
EMPLOYEE WAGE INFORMATION
GIT BUSINESS TAX RETURNS
GOVERNMENT
(Treasury)
LOSSES
BOOKKEEPING AND
RECORD RETENTION
TO EFFECT THE GIT SYSTEM
(30% OF THAT REQUIRED BY NIT)

GIT SYSTEM
ADMINISTRATIVE WORK FLOW

Figure B

Revised 6-1-81

[EXHIBIT V]

TAX EQUATION

Any income tax system equation takes the traditional mathematical form:

$$Y = m(x-a) \pm b \qquad \text{Equation 1}$$

This is a straight line function if m is a constant. Thus it is the equation form for the "Flat Rate" tax, if it is a true flat rate. If m is a constant within certain brackets or segments and the segments intersect or are connected end-to-end, then it represents a tax system with constant rates m1, m2—mj where j represents the last bracket. In our present NIT system we have 16 such ms or brackets, the Bradley-Gephardt and Kemp-Kasten proposals have 3 ms or brackets. The other across-the-board flat rate proposals have only one m or bracket. The GIT would have only one m or bracket but the base would be different.

If we now put equation into tax parlance the equation would look like this:

$$R = r(t-d) \pm nc \qquad \text{Equation 2}$$

Where:

R=Revenue yield or taxpayer liability
r=Tax rate
t=Tax base
d=Aggregate deductions, both economic and legislated
c=Credits or surcharges
n=Rate allowed on the base of the credit

If we expand equation 2 we have

$$R = rt - rd \pm ne \qquad \text{Equation 2a}$$

Everything to the left of the ± sign in equation 2a is an above-the-line deduction. Everything to the right of the ± sign is a below-the-line credit.

It can be easily seen that the deductions (d) are operated on by the tax rate. Thus under our NIT system a high bracket taxpayer get a higher effect from above-the-line deductions than does a low bracket taxpayers.

Below-the-line credits on the other hand are not affected by general tax rates. The n (rate) may be arbitrarily assigned to fit a specific economic purpose.

The application of equation 2 to the GIT tax return (Exhibit I) is as follows:

R=Tax liability (line 23)
r=Tax rate (line 23)
t=Tax rate (line 22)
c=Applied credits (line 21)

[EXHIBIT VI]

GLOSSARY

Above-the-line.—Refers to economic deductions, exclusions and preferences above the profit and loss line. It also refers to legislated paper deductions, i.e., depreciation.

Below-the-line.—Refers to tax credits, surcharges and sometimes exemptions, i.e., a base exemption of a given dollar amount for the protection of low income wage earners or starting entrepreneurships.

BOE.—Business Operating Entity. It includes all forms—corporations, proprietorships, cooperatives, etc.

IWE.—Individual Wage Earner.

Implicit taxation.—Implicit Taxation is the cost of complying with a tax system.

OMB.—Office of Management and Budget.

IRS.—Internal Revenue Service.

Cost of goods sold.—This is defined as direct product input. For manufacturers this would include the raw materials or components which are incorporated in the finished product. For resellers this would be the wholesale price of the goods to be resold.

STATEMENT OF HENRY W. BLOCH, PRESIDENT, H&R BLOCK, INC.

Mr. Chairman and Members of the Committee, I am Henry W. Bloch, President and Chief Executive Officer of H&R Block, Inc., and I offer you a perspective based on our Company's 30 years of experience in the income tax return preparation business.

I appreciate the opportunity to present these views for your committee's consideration during its deliberations on alternatives to restructure the Internal Revenue Code.

Last year, together with our franchisees, we trained and employed over 45,000 men and women who worked in over 8,000 offices in their respective communities in the United States. Block employees prepared nearly nine million federal income tax returns—almost 10 percent of the individual income tax returns filed with the Internal Revenue Service.

I give you this brief background to show the extent of our involvement with the tax laws of our country and their administration. Aside from the Internal Revenue Service, we deal with more federal income taxpayers than any organization or individual. As a result of our close associaiton with so many taxpayers—not only in preparing their tax returns but frequently in their contracts with the IRS—we have a good idea about their views on taxes. In addition, we have also commissioned numerous marketing surveys and studies. Few, if any, individuals or organizations have been in such a unique position to learn and understand the theoretical and practical problems of income tax complexity, simplification and fairness, especially as they relate to lower to middle income taxpayers.

These lower to middle income taxpayers have no formal or recognized tax lobbyist or advocate to advance their causes, protect their interests and represent their views. Because of our intimate tax relations with so many of these taxpayers, we are probably the next best source to articulate their views.

We have been hearing and reading so much about the so-called public demand to simplify the tax law. We have also listened to the proponents of a variety of tax systems rushing in to meet this demand for simplification. Some writers on the subject contend that advocates of radical change are using the simplification issue as a reason to eliminate the principle of ability to pay upon which the current system is based. This raises the question, as attributed to Senator Russell B. Long in a newspaper article, ". . . . whether it is justifiable to shift the tax burden from the rich to the middle and low income taxpayers in the name of simplicity."

We recognize that public perception and criticism of our tax structure has reached the point where we must take a hard look at it to determine whether it is still what this country needs—and the public will accept—for its future. While reviewing it, however, let us not forget that, in spite of the initial eagerness of some to abandon it for something else, it has been and still is the envy of most other countries.

Although many alternatives to our current income tax system have been suggested—the flat tax, the consumption tax, and the value added tax—my views will concentrate on the various "flat tax" or "modified flat tax" proposals about which I am convinced that our experience as the country's largest income tax return preparer uniquely qualifies us to comment.

I readily acknowledge that we have a vital interest in the form of the federal income tax structure and the way in which Federal income tax legislation would affect the American taxpayer and his or her utilization of our services. However, I must emphasize that many of the flat tax proposals, if enacted, would not have as much of an adverse impact on our business as has at times been suggested. Most of them contemplate retaining some business deductions and a number of personal itemized deductions and, based on our market analysis, we would retain a very significant portion of our business. In addition, you should know that an increasing percentage of our business already serves taxpayers who only file simplified forms. For example, in the 1984 tax season approximately 25% of the federal returns we prepared were on Forms 1040A and 1040EZ. The flat tax proposals are not likely to result in forms that are simpler than the forms 1040A and 1040EZ. Furthermore, taxpayers come to us for assistance in the preparation of state income tax returns which would not be affected by flat tax proposals. Accordingly, I would stress that while we have a considerable interest in the form of the federal income tax structure, we are not primarily motivated today by concern for our financial health. We are confident that under almost any federal income tax structure that may be adopted, a significant proportion of the country's taxpayers will need and want tax return preparation services. H & R Block, and the other members of the tax return preparation industry, will be in business in 1985 regardless of the form of any Federal income tax legislation that may be enacted.

Our desire to present our views is motivated very sincerely to preserve a fair and equitable income tax system—one which for many years has proven itself eminently fair to the overwhelming majority of taxpayers. The long-term interests of our country are best served by a tax system which is fair and which is perceived by taxpayers as fair. Fairness should be our primary focus and concern.

Our opposition to the flat tax proposals is based upon many reasons. Let me cite three principal ones. First, although they appear alluringly simple, the flat tax proposals are not fair. Secondly, they will over the long-run fail to simplify the income tax structure in any significant way. Thirdly, the flat tax proposals will have some predictable and negative consequences which will be harmful to our entire social and economic system.

The first principal reason—that the flat tax proposals are unfair—is based on the cardinal fairness principle of the current federal income tax system. It is that the tax burden must be distributed in accordance with a taxpayer's ability to pay.

A taxpayer's ability to pay depends upon both his personal circumstances and upon his level of income. Fairness of the distribution of taxes among taxpayers with equal incomes is sometimes referred to as "horizontal equity" and the fairness of the distribution of taxes among taxpayers with different incomes is sometimes referred to as "vertical equity."

Many exemptions, deductions and credits take into account a taxpayer's personal circumstances. I offer several examples which will illustrate the proposition. If two taxpayers have equal income, but one taxpayer has a $20,000 casualty loss and the other does not, is it fair to impose the same tax burden on each taxpayer? Similarly, if two taxpayers have equal income but one taxpayer has $20,000 of uninsured medical expenses and the other has none, is it fair to impose the same tax burden on each taxpayer? If two families have equal income but both parents in one family work to earn that income and, therefore, that family must incur child care expenses while the other family has no child care expenses, is it fair to impose the same tax burden on each family? Current laws would provide for some relief in the tax burden for the taxpayer incurring the casualty loss, paying the medical expenses or incurring the child care expenses. Most flat tax proposals would not.

Other examples readily come to mind. The critical fact is that the current system attempts to achieve a fair distribution of the tax burden by making logical and rational distinctions based upon a taxpayer's personal circumstances which affect his ability to pay. A system which fails to make these distinctions would be unjust and unacceptable to American taxpayers. Yet one of the significant features of the flat tax proposals is precisely the elimination of these distinctions based on ability to pay.

A progressive rate structure is also fundamental to any fair tax system. Taxpayers should pay taxes at higher rates on higher levels of income than on lower levels of income. American citizens have spoken clearly and with consistency through their elected representatives in favor of a progressive or graduated rate structure. Yet another significant feature of the flat tax proposals is either the elimination of sharp reduction in the progressiveness of the rate structure.

We conclude that the two significant features of the flat tax proposals would both tend to make the system less fair than the current system. The elimination of exemptions, deductions and credits would mean the taxpayers with similar amounts of income but entirely different personal circumstances would pay the same tax. The elimination of the progressive rate structure would mean the taxpayers with significantly different amounts of income would pay taxes at the same rate.

We also believe it would be unfair to change the tax laws in ways which would penalize taxpayers who have acted in reliance on the existing tax laws. For example, our tax laws now encourage home ownership through deductions for home mortgage interest and real estate taxes. It would be unfair to a taxpayer who assumed significant long-term financial obligations in reliance on such deductions to eliminate them now.

Our second objection to the flat tax proposals is that we seriously doubt that they will be much simpler than the current system. The proposals do give the illusion of simplicity, at least initially, by reducing the number of exemptions, deductions and credits. However, one aspect of simplicity which has been largely overlooked in the current debate is the simplicity that results from stability. Unfortunately, our federal income tax system has in recent years been anything but stable. Since 1976 alone, we have had eight separate major revisions in our tax laws and, each year, the taxpayers must attempt to comply with the changes. To add to the aggravation, the changes seem often merely to revise the previous changes or to go in full circle. For example, the capital gains holding period has been changed from six months to nine months to one year and back to six months. Of course, a number of changes were necessary to prevent abuse of the tax law and such changes are essential to make the tax law fair.

The lessons of the recent legislation call into question the promises that flat tax proposals would be simpler. Taxpayers would be required to learn a substantially different system. That, in itself, would not be simple and undoubtedly would cause some initial compliance problems.

Because most of the existing deductions, credits and exemptions resulted from a desire to be fair and for legitimate social, economic and political needs which are still present, we anticipate that the flat tax would almost certainly be amended to add substantially the same exemptions, deductions, and credits that had been removed. We believe that the flat tax, if enacted, would go the way of the capital gains holding period and would not, therefore, either initially or ultimately, result in simplification. Senator Russell Long has stated that "I know that once one type of deduction in a flat tax system is allowed, Congress would be unable to resist the pressure for numerous other deducations."

In this regard, it should be noted that flat tax proponents originally advocated the complete elimination of any deductions, credits or exemptions. However, even they now recognize that some deductions such as interest payments and charitable contributions are still necessary. But this modified approach ignores the background for other exemptions, deductions and credits. Almost without exception, each has been adopted to achieve certain social and economic incentives and objectives, all of which, at least at the time of enactment, were acknowledged to be worthwhile. For example, tax credits have been offered to increase employment and to encourage rehabilitation of existing structures. Intangible drilling cost deductions are available to encourage the search for energy. One could go on and on with various other illustrations of the need for deductions, exemptions and credits in our society and each would arguably serve important and legitimate objectives from social policy to national defense. Many of these objectives have been largely met without establishing new administrative bureaucracies with large offices, voluminous paperwork and oppressive regulations with their corresponding new program costs.

Indeed, the most refreshing "simplification" to the federal income tax system would be to reduce the continuous tinkering with the system which has marked the last several years. I say this in spite of the fact that this constant tinkering does help our business.

Our third reason for opposing flat tax proposals is the application of the so-called rule of unintended consequences. It is now widely acknowledged that radical changes in major systems in our society produce an array of both intended and unintended consequences. For example, certain environmental programs may have the intended consequence of preserving treses and open spaces for future generations but also have the unintended consequence of preventing economic development and job creation in areas of high unemployment.

We believe that the potentital unintended consequences of a flat rate income tax may be enormously detrimental to society. Most importantly, the flat tax proposals would undoubtedly shift tax burdens among taxpayers with different levels of income. For example, the Congressional Research Service report on flat-rate tax proposals dated May 26, 1982 concluded that "unless some form of low to middle income relief were included, a flat-rate income tax would produce a tax burden which would fall more heavily on lower to middle income taxpayers than the present system." Mot of our customers are average working people who are not rich. We are concerned about any proposal which will increase the tax burden on average working people.

In addition, the tax burden among taxpayers with the same levels of income could also be shifted. For example, under the Kemp-Kasten Fair and Simple Tax proposal, an elderly couple that does not use a tax shelter, takes a standard deduction, and has an annual income of $40,000 from their pensions would have their taxes increase by $1,000. On the other hand, a family of four, likewise using no tax shelter, taking the standard deduction and earning $40,000 in wage income would have their taxes decrease by $1,356. We do not mean to single out the Fair and Simple tax proposal for criticism. It is clear that all of the flat tax proposals would have the unintended consequences of making significant changes in the tax burdens of numerous individual taxpayers.

Other unintended consequences also come to mind. For example, would charitable contributions be reduced if they were no longer deductible? Would charitable contributions be reduced even if they were deductible but the highest federal income tax bracket would be reduced? What effect would a flat tax have on employment in the housing industry? How would the elimination of investment tax credits affect employment in manufacturing industries? How would the elimination of intangible drilling cost deductions affect energy prices? These impacts cannot be ignored for it is clear that the more radical the change in the tax laws, the more significant will be the unintended consequences.

We are convinced that the flat tax proposals are unfair, would probably not result in any meaningful simplification and would certainly lead to many unintended adverse collateral consequences. You have undoubtedly heard most of these concerns before. Indeed, the analysis prepared by the staff of the joint committee on taxation on September 24, 1982 confirms our conclusions by stating that "a very simple tax system, however, may rank low from the equity and efficiency viewpoints." And Representative Barber Conable of the House Ways and Means Committee was recently quoted as saying "Let's not hunker down and assume that simplicity means a fairer tax."

We recognize that the present system is complex and simplicity is very appealing. However, even if we all agree that the present system is fairer and more equitable than a flat tax system, some may think that the costs of the current system outweigh the value of fairness. What then is the direct cost of the current complexity in our federal income tax system to the average American taxpayer? It's $40. For the nearly 9,000,000 returns H & R Block offices prepared in 1984, the average charge was about $40 for the federal and state returns. I am not here speaking for the large corporations or the wealthy individuals with their batteries of tax accountants and lawyers. Our customers are average working people from average working families.

Is $40 too high a price for fairness? We think not and our customers obviously think not. We believe that H & R Block and the tax preparation industry generally perform extremely well in delivering services to average working people at a very reasonable price. Clearly, the elderly couple described earlier would rather pay a $40 return preparation fee than have their taxes increase by $1,100. Do you think our customers generally would prefer to have their deductions and credits eliminated in order to save $40? We can categorically tell you they would not.

Nor do we think that the entire income tax system should be radically altered so that the corporations and wealthy of our society can live in a less complex world. If the corporations and wealthy of our society choose to engage in transactions which require the use of sophisticated tax planning and advice, so be it. We strongly believe that you should not take away the advantages of the current system to the average working family in order to protect the corporations and wealthy from a complex society. It is the wealthy of our society who take advantage of abusive tax loopholes and who pay the so-called "audit lottery", whereby a taxpayer either hides a highly questionable item on his return or shows it but resolves it in his favor "taking a chance" that he will not be audited. Congress has just passed the Deficit Reduction Act of 1984 which addresses some of these practices. Congress was clearly correct to address the specific abuses directly through such targeted legislation.

Flat tax proposals are ideas whose time has come and gone. In 1913, after the ratification of the Sixteenth Amendment, Congress imposed a federal income tax with a graduated rate of from one to six percent and from a $3,000 personal exemption with an additional $1,000 exemption for a married person. Corporate net income was subject to a 1% tax. In effect, in 1983 we had a modified tax structure.

As appealing as the simplicity of 1913 is retrospectively, it is impossible to recapture that simplicity with fairness for all in today's complex society.

In 1913, for example, it was less common for both spouses of a marriage to work outside the home. But in 1984, many of our households do just that and the deduction for two wage-earner households and the credit for child and disabled dependent care are appropriate congressional responses to these contemporary conditions. Perhaps in 1913, the country did not have the social conscience or the economic wisdom to encourage the employment of disadvantaged classes of our citizens. Today, however, social responsibility is acknowledged as essential to the welfare of the nation and so we have a jobs tax credit to encourage the employment of such unfortunate people—a vitally important and appropriate governmental response to these conditions.

Modern life's complexities cannot be legislated away. Seventy-five years ago we did not have a federal income tax or an Internal Revenue Service. Fifty-five years ago we did not have federal regulation of our securities industry or a Securities and Exchange Commisssion. Twenty years ago we did not have federal regulation of the environment or an Environmental Protection Agency. The nature of our society has changed and in each of these instances, as well as in many more than can be cited, the American people through their representatives have responded to the growing complexity of life. The touchstone of their response has been fairness.

Even as we are reexamining many of our laws and regulations, few ardent supporters of change will suggest that the regulation of the securities industry or the environment be eliminated completely. Similarly, we believe that the federal income tax system should not be eliminated in its entirety to make way for the system which was in place in 1913. Rather, you should examine the specifics of the present system. If some provisions are not performing their intended function at an acceptable cost, then change those particular provisions. Do not throw out the baby with the bath water. A dramatic and radical change will create more confusion and unfairness and further alienate taxpayers.

As previously mentioned, Congress has just passed the Deficit Reduction Act of 1984 which forecloses some abusive tax "loopholes" and tax shelters. We certainly applaud that effort. Following that with changes which would be made by a flat tax would not be perceived by taxpayers as eliminating inequities or closing more loopholes, but rather as an abandonment of fundamental cornerstores of a rational tax system. And, a dramatic reduction in the highest tax rate would be perceived by taxpayers as opening the biggest loophole of all.

According to a Harris Survey conducted in August, 1981, a proposal to abandon the graduated income tax for a flat tax system under which everyone would pay a 20 percent federal income tax met with a resounding rejection by 61-34 percent. The survey also showed that all groups below the $35,000 income level—the people with whom we mostly deal—want to retain the progressive tax system.

The flat tax proposals would not be fair and would not be perceived as fair. They would certainly work an unintended hardship on many taxpayers and they would not simplify the system in any real or permanent manner. The proposals would, at an unknown but surely extravagant cost, attempt to solve a problem which average American working taxpayers can either solve themselves or solve for $40 with the assistance of a commercial income tax return preparer.

With respect to those 40 percent of all individual taxpayers—36 million of them—who do not itemize deductions and file the short forms 1040A and 1040EZ—*a less* drastic solution to the complexity they face is currently awaiting some action in your committee. It is H.R. 4305, a bill which would give those non-itemizing taxpayers a small partial credit for tax return preparation expenses. The proposal would make professional tax return preparation more accessible to those taxpayers with lower incomes and less education. It would also enhance fairness by eliminating the glaring inequity now existing between taxpayers who itemize—who are encouraged to seek professional help because they may deduct the fee—and those who cannot.

Simplistic proposals during political campaigns often drive out good policy. Today's debates over our tax system—expecially the deceptively quick-flat tax alternatives to our existing tax system—are examples of simplistic proposals which threaten to drive out a generally good self-assessment income tax system that cannot be matched by any other country. There has rarely been a greater example of the genius of our lawmakers than the current progressive income tax system which, in addition to raising the revenue it does, has been used as fine-tuned, sophisticated vehicle to accomplish public interest social and economic objectives.

Certainly our system lacks simplicity, but equity and fairness often require some complexity. The basic question for you to answer is how much equity and fairness is worth how much complexity. We believe the complexity that comes from distributing the tax burden in accordance to a taxpayer's ability to pay, based both upon his level of income and personal circumstances, are well worth the fundamental equity and fairness they achieve. And we think most taxpayers agree with us.

To the extent that public confidence in our system needs to be rebuilt, we think you have begun that already by eliminating compliance loopholes and abuse-prone provisions in 1982 and 1984. Thank you for the opportunity to submit these views and for including them in the printed record of your hearings.

HIGHWAY USERS FEDERATION,
Washington, DC, September 25, 1984.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives,
Longworth House Office Building,
Washington, DC.

DEAR MR. CHAIRMAN: The Highway Users Federation is a national, longstanding coalition of businesses, industries and associations working to make America's highway transportation systems safer and more efficient. Our members are the chief users of highway and the main providers of highways transportation products and services.

We appreciate the opportunity to submit material for your Committee's early discussions on deficit reduction. We hope our comments will be incorporated into the formal hearing record.

Taxes for general public purposes should have the widest possible base and should fall equitably among taxpayers. We oppose special energy taxation for such purposes. However, if an energy tax is incorporated in a larger tax package, it should be fairly imposed on all energy sources. An oil excise tax, such as the one proposed by the Administration last year, does not provide this equity.

There are vast geographical inequities in an oil tax. Taxing petroleum for general government purposes distorts the responsibility of different regions of the country for reducing the federal deficit. Under an oil tax, consumers in the West, who use more gasoline than the national average, would bear a disproportionate share of the financial burden. Americans in Wyoming typically drive over twice as much as people in New York. There is no logic in making a Wyoming family bear a greater burden of the federal deficit than a family in New York. The tax will pit Westerners against Easterners and urbanites against rural and suburban dwellers.

From the highway user perspective, petroleum use is already heavily taxed—in some states at more than 20 percent of value—by federal and state taxes. Highway users cannot shift to other kinds of fuel and must use oil regardless of the cost.

There are gross social inequities in an oil tax. Taxing oil, particularly gasoline, is regressive because it hits hardest those least able to pay. Because the tax is regressive the social cost will be exceedingly high. A 1977 U.S. Department of Transportation study shows that 80 percent of Americans earning less than $5,000 a year commute to work by private motor vehicles. These citizens would suffer most under an oil tax.

Inequities also arise from the way government administers oil taxes. Special treatment for some users always accompanies consideration of an oil tax. The history of the Mandatory Oil Import Program in the 1960s and the price and allocation control program in the 1970s demonstrates this. For example, the U.S. Department of Energy's "entitlement program" under price controls was intended to equalize crude oil costs between refiners. But special treatment and exemptions were used to favor certain classes of refiners and users of heating oil. Similarly, President Carter's proposed oil import fee was intended to be passed through entirely to retail gasoline sales. Special treatment and exemptions from an oil excise tax ultimately would be granted to various classes of consumers. This pattern of tax implementation means the burden would fall only on certain groups.

An oil tax would have a direct and damaging effect on highway transportation. New taxes should not disrupt the well-established and accepted linkage of user charges to public services, such as those provided in state and federal highway trust funds. An excise tax on oil for *general* fund purposes would effectively preempt the funding source that since 1919 has been largely reserved for highways in the states. At present, motor fuel taxes at both the state and federal levels enjoy strong public support because they are clearly and correctly perceived as user charges imposed for the construction and upkeep of our nation's roads. Generally, these revenues are dedicated to highway trust funds for that purpose.

Evidence of public support for highway earmarked fuel taxes can be seen in the states. Contrary to the pattern of state tax limitation in recent years, state highway user charges have been widely and substantially increased to deal with serious road problems. In the coming years, states will seek further fuel tax increases to match increased federal road funding from the nickel-a-gallon fuel tax hike. So far, 33 states and the District of Columbia have passed motor fuel tax increases to raise matching state funds.

Over-reliance on a single-product tax has proven unwise government policy in the past. The so-called "Windfall profits" tax provides a recent example. In 1980, income from the tax was estimated to be $227 billion over a ten year period. Because of conservation, worldwide recession and falling oil prices, the revenue projection has been scaled down to $75 billion, a $152 billion miscalculation. Such tax schemes do not solve the deficit problem, they contribute to it.

In sum, deficit reduction efforts utilizing oil taxes are: (1) inequitable; (2) preempt the nation's dedicated funding sources for highways; and (3) focus deficit-reduction strategies too narrowly.

The major argument for an oil tax is to reduce the deficit. But the net effect is uncertain. Since the tax would depress the overall economy, revenues from traditional sources such as income taxes would drop, while government entitlement expenditures would rise to assist those Americans added to the unemployment rolls.

Sincerely,

PETER G. KOLTNOW,
President.

STATEMENT OF THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

The Independent Petroleum Association of America is a national organization composed of some 7,000 independent oil and natural gas producers located in every producing area of the United States. THe IPAA, together with the 29 unaffiliated oil and gas associations listed on the cover page, represents virtually all of the independent producers and thousands of royalty owners in the United States. We are grateful for the opportunity to provide comments on the direction of our national tax policy, an area which has broad application and will directly affect our industry and have personal impact upon our members.

During the course of these hearings, the committee has heard much criticism and scant praise of our present method of taxation. The testimony has applied the traditional criteria of simplicity, equity and efficiency, commonly used to examine the desirability of any tax, to point out the failures of our system. While there is unquestionably much to criticize about the method we have employed to fund our government, the short comings of our system should be viewed from a broader perspective.

An objective appraisal of our income tax must be careful not to examine the tax system in a vacuum by merely applying academic standards which only measure its effectiveness as a means of raising revenue. Our current system has never functioned in this manner. Almost from inception it has been viewed source but an efficient vehicle for accomplishing the objectives of government policy.

The relationship between these government policy objectives and the economic standards of a desirable tax somehow seem obscured by the current debate. The problems of the current tax system reflect not only internal trade-offs between the goals of simplicity, equity and efficiency but also significant trade-offs between these goals and desires to accomplish other public purposes. For example, a theoretical ideal tax system should be both simple and equitable. Yet, the conflict between simplicity and equity is so great as to make them nearly mutually exclusive. The vast complexity of the internal revenue code has developed not through some preverse desire to make the law impenetrable to the average American, but through endless legislative compromises in the attempts to achieve greater "fairness."

A great deal of simplicity could be achieved by eliminating distinctions between ordinary income and capital gains yet these distinctions arose to make our system more equitable. Within a system which entailed steeply progressive marginal tax rates it is believed necessary to distinguish between income arising in the ordinary conduct of business from accretions to value which have occurred over an extended period of time. This rationale could of course be eliminated by reducing the progressivity of the tax rates but, again, does that achieve greater or lesser equity. There is no shortage of examples of situations in which our current tax system has sacrificed simplicity in the name of further fairness. In our dynamic political process it is doubtful that any straightforward federal revenue measure could remain simple for any extended period of time. There will be continual "reform" in the search for greater equity. Most of such changes would result, as in the past, from the recognition that is not alike, and that stimulation of particularly critical economic activity can be achieved only by differential tax treatment.

The complexity and inequity of our current method of financing our government do not deserve to be defended. However, any attempt to further "reform" our current revenue system must be viewed with great skepticism. Although the objective is truly laudable, is it possible to have a popular and painless method of financing government activities?

With our current tax system comes the greatest academic criticism for its failure to meet the standard of economic efficiency. Since certain forms of savings and certain forms of investment are currently given favorable treatment under the Internal Revenue Code, this favorable tax treatment will affect rates of return from those activities. By significantly impacting the after tax rate of return the tax system functions to allocate resources in a manner different from what would occur if no tax system existed. The resulting change in investment patterns is viewed as distorting the over-all economy. This is of course correct, and far from being unintended it is precisely for this reason that most of the differential provisions were enacted. The role of tax policy in providing incentives to channel private investment in a manner which reflects the goals of public policy has been recognized as a fundamental of taxation since the inception of our income tax.

U.S. tax policy is also being guided by a desire to tax all enterprises in a manner which reflects their unique characteristics. There are numerous examples of specific provisions in the Internal Revenue Code which were enacted in recognition of these principles. Providing deductions for home mortgage interest, charitable contributions, credits for research and development, credits for investment in machinery and equipment, and deductions for intangible drilling costs, were enacted to encourage, respectively, homeownership, philanthropy, fundamental research, expansion of industrial capacity, and development of domestic energy production. Different taxing schemes have also been employed to account for fundamental differences in the nature of such businesses as public utilities, farmer's cooperatives, banks, savings and loan associations, insurance companies, real estate investment trusts, and the list could continue.

These principles likewise influenced the taxation of the petroleum industry from the beginnings of the income tax. Tax incentives for producers have proven to be an efficient vehicle of accomplishing the objectives of government policy. The close relationship between government tax and pricing policy and the industry response has been clearly demonstrated. A statistically significant positive relationship exists between the historical oil and gas tax incentives, the current deduction of intangible drilling costs and the provision for percentage depletion, and the rate of net investment in proved reserves through drilling. The option to deduct intangible drilling costs and the recognition of depletion are not the product of congressional favoritism to a special class of taxpayer. These provisions have endured through seventy years of economic change only because they make good sense. These provisions, although perhaps imperfect, exist in recognition of the need to provide incentives for exploration and development of crude oil and natural gas. It goes without saying that in the absence of the spending thus generated we are simply liquidating our known reserves.

While in concept an ideal tax system might be one which is neutral with respect to all investments it does not necessarily follow that government should be similarly neutral regarding the allocation of its national resources. We believe it is a legitimate function of government to encourage the development of our mineral resources, along with many other forms of activity. Although utilizing the tax system as the means to provide the necessary incentive may make the tax system less "economically efficient," in a theoretical sense, it is nevertheless the most efficient means the government has at its disposal of providing those incentives. And this role must not be forgotten.

Our tax system is far from ideal. The existing high marginal rates continue to stifle economic growth. Compliance with the awesome complexity of the Internal Revenue Code is a burden to productivity. Yet despite these glaring deficiencies we have adapted to the system. Our investors and operators have grown accustomed to and dependent on existing tax incentives to facilitate sufficient capital formation to maintain our reserve of hydrocarbons. While the prospect of a simple tax system is alluring a realistic analysis provides little evidence that it is either attainable or desirable. No simple system can address a society and business structure as complex as that which exists in our nation today and regardless of the simplicity no tax system will remain popular when the time comes to pay.

ABSTRACT OF DISSERTATION TITLED "TAXPAYERS PERCEPTIONS OF TAX COMPLEXITY AND THE EFFECT OF COMPLEXITY ON REPORTING POSITIONS," COMPLETED MAY 1984, UNIVERSITY OF SOUTHERN CALIFORNIA

(By Valerie C. Milliron, Assistant Professor of Accounting, Pennsylvania State University)

ABSTRACT

This study provides professionals involved in tax administration, compliance and policy matters with insight into the meaning and influence of tax complexity. Although extensive research has been conducted on the magnitude of the tax gap, little has been done to ascertain why this gap exists. This research attempts to define and measure one suspected tax gap influence—tax complexity. This is a two-part study. Phase 1 is devoted to empiracally defining tax complexity, Phase 2 to testing its effects.

For both Phase 1 and Phase 2 testing, the author selected subjects randomly from taxpayers awaiting jury duty at the Los Angeles County Courthouse. Thirty subjects, taking an average of 70 minutes each, participated in the Phase 1 testing. Eighty-six subjects, averaging 20 minutes each, participated in Phase 2. The demographic data collected indicates that these 116 subjects represent a cross section of Los Angeles area taxpayers.

Phase 1 utilizes multi-dimensional scaling to derive an empirically based definition of tax complexity. This definition helps explain the relationship between complexity and other concepts and provides a scientifically defensible base for testing the effect of complexity. Phase 2 addresses the issue of whether complexity influences one's tax reporting position. Testing four distinct tax cases, the author shows that complexity has a significant effect in every case.

A secondary issue in Phase 2 is whether taxpayers tend toward noncompliant reporting positions as measured by what they perceive or would advise as correct. In all four cases the mean for "what you would report" reflected a more aggressive tax stance than "what you would advise," which is still more aggressive than "what you think is correct." And in three of the four cases, "what you think is correct" is definitely more aggressive than the IRS tax position. What is especially disturbing from a tax administration perspective is that 56 of the 86 subjects (67%) selected reporting positions that deviated in their favor from their own perception of the correct reporting position in one or more of the four cases. Moreover, all population subgroups revealed an equal propensity to evade.

Statement of Jack Carlson, Executive Vice President and Chief Economist, National Association of Realtors

I am Jack Carlson, Executive Vice President and Chief Economist of the National Association of Realtors. On behalf of the more than 600,000 members of the National Association, we greatly appreciate the opportunity of testifying before the House Committee on Ways and Means as you consider proposals to reduce the federal budget deficit and reform the federal tax system. We are pleased to respond to this Committee's request for our views on (1) the federal deficit and how it affects interest rates, capital formation, and foreign competition; (2) tax reform policy and fundamental tax restructuring; and (3) consumption taxes.

RECOMMENDATIONS

We believe that prolonged high budget deficits threatens sustained economic growth and prosperity. Federal budget deficits create high real interest rates which overvalue the dollar, thus crippling exports, causing a recession in agriculture, damaging industries which compete with imports, causing record balance of payments deficits, and intensifying a growing international debt problem. Deficit-caused high real interest rates reduce investment in people (education and training), reduce investment in structures (residential, commercial, industrial, and agricultural), and reduce homeownership. Less long-term investment slows growth in the nation's capacity to grow, slows growth in productivity, results in fewer and less rewarding jobs, and slows growth in the American standard of living and quality of life.

The National Association of Realtors has a long history of expressing concern to the Congress and the President about both the negative impact of federal deficits on the economy and of advocating the importance of increasing savings and investment to raise the long-term growth prospects of the economy. As a continuation of this effort, we have recently joined with the bipartisan group of former Secretaries of Treasury and Commerce, with 500 business leaders, and with 32 other professional organizations to form the Bipartisan Budget Coalition.

We strongly recommend the following program to reduce federal budget deficits and to do so in a way that will not discourage savings and investment in people, in structures, in long-life equipment and in homeownership. This program has also been endorsed by other members of the Coalition.

1. A freeze of at least one year—preferably two—in cost-of-living adjustments (COLAs) for the large, non-means tested spending programs;
2. A cap on future indexing of spending programs and of personal income tax brackets (e.g., at 60 percent of the Consumer Price Index (CPI) or at 2 to 3 percentage points less than the CPI);
3. Similar restraints on all other transfers, subsidies, and programs beyond those for means-tested programs;
4. A multi-year defense buildup at a more moderate pace (real growth of no more than 3 to 5 percent); and

5. Once spending cuts of the type and magnitude described above are assured, any revenue measures needed to reach the deficit reduction goal should mainly rely on consumption-oriented taxes in order to avoid weakening incentives to work, save, and invest. However, any tax increases should be tied to and exceeded by spending cuts.

Such a deficit-reduction program should be considered and recommended by the President in his January 1985 budget and adopted by the Congress next year in its budget and appropriations processes. If enacted, the program would reduce the annual federal deficit by $185 billion by the end of the decade, would lower real interest rates by 3 percentage points, would increase commercial, industrial, and agricultural investment by 11 percent, would increase residential investment and homeownership, and would result in over 2 million more jobs and raise household income by $1,800 (see Figures 15, 16 and 17).

We also recommend a Constitutional Amendment to make it more difficult to create and maintain massive and harmful deficits through irresponsible spending and to prevent a deficit by irresponsible cuts in tax revenue. Deficit budgets caused by excessive spending or tax cuts should be approved by a 60 percent vote in the Senate and House of Representatives. We also recommend that the President be given additional and substantial line-item veto authority.

We are greatly disappointed that tax policy, even with the changes by Congress and the President during the last four years, still does not encourage enough savings and adequate investment in people, in structures, in long-life equipment and in homeownership.

We believe changes in tax policy should:

1. Be designed to result in higher living standards by encouraging growth in savings and investment. Current tax policy does not encourage enough savings and investment. Domestic investment as a percentage of national output has been much lower during the last four years compared to the previous 3 decades and is forecast to grow slowly during he next five years (see Figures 8, 9 and 10). Savings and investment in the United States is the lowest among industrialized countries (see Figure 11).

2. Encourage homeownership. Homeowners in all income classes save more than nonhomeowners of the same income—on average about 50 percent more (see Figure 23). Encouraging homeownership, therefore, results in greater savings for residential investment and greater savings for commercial, industrial, and agricultural investment. Homeownership leads to greater family stability and neighborhood solidarity, less crime and violence, and higher voting participation, making democrary more effective an meaningful. Homeownership reduces the need for growth in government mandated retirement programs such as Social Security. The homeownership rate has dropped since 1980 for the first time in 40 years primarily as a result of fiscal and tax policies. Unless policy changes, the declining trend in homeownership will likely continue for the foreseeable future (see Figures 5 and 6). Should the rate of homeownership continue to decline as it has since 1980, the nation will likely experience less savings, less investment, less growth and higher inflation (see Figure 24).

3. Limit use of the CPI in adjusting personal income tax brackets because of its past and current overstatement of increases in the true cost of living. Rather, impose a temporary freeze and/or accept CPI minus 3 (or minus 2) percentage points to make this correction. This change should be done simultaneously with and in the same legislative act as limiting COLA indexing of large, non-means-tested pending programs such as Social Security and government retirement.

4. Be modest and provide for smooth transition so as not to disrupt the economy or drasitically change the value of individual assets and after-tax imcomes. Tax changes concerning accelerated cost recovery—passed by Congress and adopted by the President this year—have significantly reduced the value of rental residential properties and commercial and industrial buildings by $135 billion (see Figure 22), and will cause an annual decline of 4.8 percent in investment in commercial, industrial, and rental residential structures which will increase rents equivalent to 2 percent of the median income of all renters, about 4 percent of the income of low-income renters (see Figure 21).

5. Recognize that the benefits of economic growth and expansion of the earned income refundable tax credit (negative income tax) have and will reduce the need to expand spending programs or other tax provisions to overcome poverty.

6. Reduce the harrassing, overly detailed and complex provisions of current tax policy that limit individual choice, freedom, understanding and compliance.

7. Reduce corporate tax rates, reduce the tax on capital gains, and begin to eliminate the double taxation of corporate income.

Tax reform should foster more adequate savings and investment in people, in structures, in long-life equipment and in homeownership for greater economic growth and efficiency. Tax reform should promote fairness, democracy, compliance and adequate revenues for appropriate spending programs.

We recommend against enacting radical flat rate tax proposals (such as those proposed by Gephardt and Bradley, Kemp and Kasten, Siljander and Deconcini) because they do not meet all of the above criteria. We believe a modest lowering of tax rates with additional incentives for savings, investment and homeownership would be more appropriate.

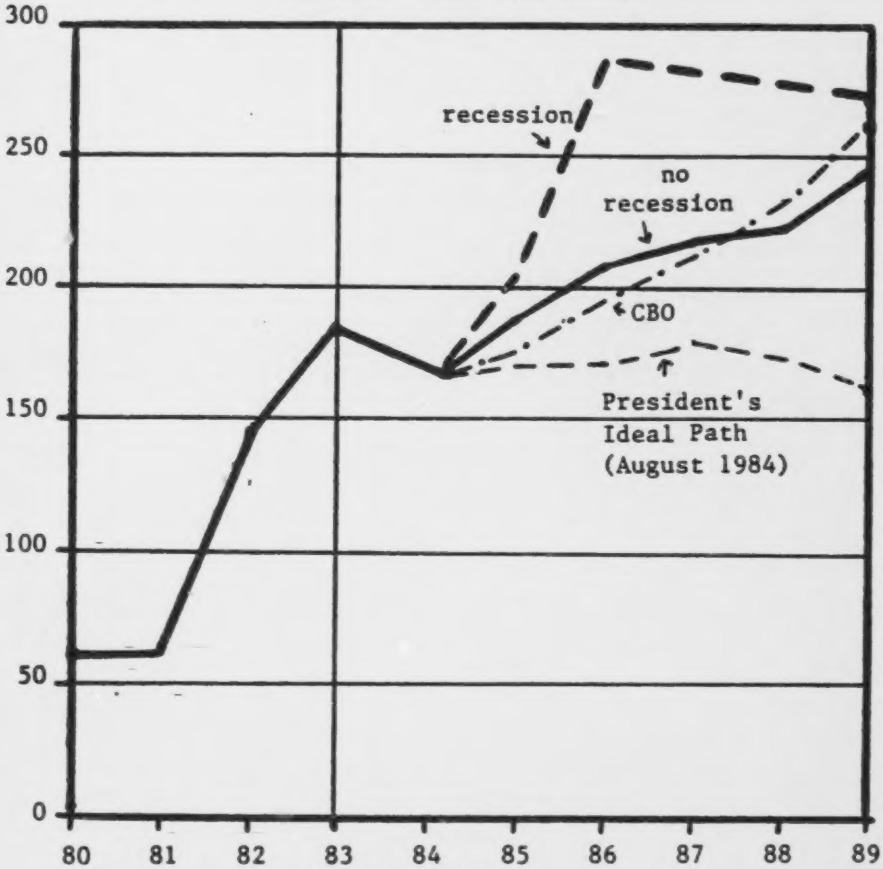
We recommend continued reliance on and improvements of the existing progressive personal income tax with greater encouragement for savings, investment and homeownership than now exists.

THE NEED TO REDUCE THE FEDERAL BUDGET DEFICIT

Our industry is very concerned about the effect of huge federal budget deficits and projected deficits for 1985 and future years. We recently completed an update of the budget outlook based on a revised set of economic assumptions and taking into account the deficit-reduction actions of 1984. Our most optimistic forecast, which assumes no recession in the next five years, has budget deficits growing from about $180 billion in 1984 to almost $250 billion by 1989. Our "no recession" forecast is close to recent estimates by the Congressional Budget Office (CBO), but is sharply higher than projections from the Office of Management and Budget (OMB) (President's ideal path—August 1984).

FIGURE 1

COMPARISON OF FEDERAL DEFICIT PROJECTIONS
(Calendar Year, NIA Basis)



Source: The "recession" and "no recession" estimates from the NATIONAL ASSOCIATION OF REALTORS® based on a simulation of the Data Resources, Inc. model of the U.S. economy. The CBO estimate from the Congressional Budget Office, The Economic and Budget Outlook: An Update, August 1984. The "President's Ideal Path" from the Office of Management and Budget, Mid-Session Review of the 1985 Budget, August 15, 1984.

It is unlikely, however, that the "no recession", the CBO or the OMB deficit projections will be achieved. None of these projections includes a recession at any time over the next five years. During peacetime, there has never been as long a recovery as these forecasts assume.

FIGURE 2.—DURATION AND STRENGTH OF ECONOMIC RECOVERIES DURING PEACETIME COMPARED WITH THE ADMINISTRATION'S [OMB] AND CBO'S PROJECTIONS

	Trough	Peak	Duration	Percent change in real GNP	Average annual percent change in real GNP
OMB projection (Aug. 1984)	82:4	89:4	28 (quarters)	30.6	4.6
CBO projection (Aug. 1984)	82:4	89:4	28 (quarters)	26.0	3.9
NAR projection (no recession)	82:4	89:4	28 (quarters)	26.7	3.9
NAR forecast (recession)	82:4	85:4–86:4	12–16 (quarters)	14–18	5–5.5
Average of last 30 years			13 (quarters)	16.6	4.8
Average of peacetime recoveries	80:2	81:3	5 (quarters)	4.4	3.5
	75:1	80:1	20 (quarters)	24.3	4.4
	70:4	73:4	12 (quarters)	16.7	5.3
	60:4	[1]65:4	20 (quarters)	29.7	5.3
	58:1	60:1	8 (quarters)	11.3	5.5
	54:2	57:3	13 (quarters)	13.2	3.9

[1] After 65:4, stimulus came from the Vietnam War and caused continuous growth and a doubling of the higher inflation rate until 69:3.

Source: Analysis by the National Association of Realtors®. See Congressional Budget Office, "The Economic and Budget Outlook: An Update," August 1984 and Office of Management and Budget, "Mid-Session Review of the 1985 Budget," August 15, 1984.

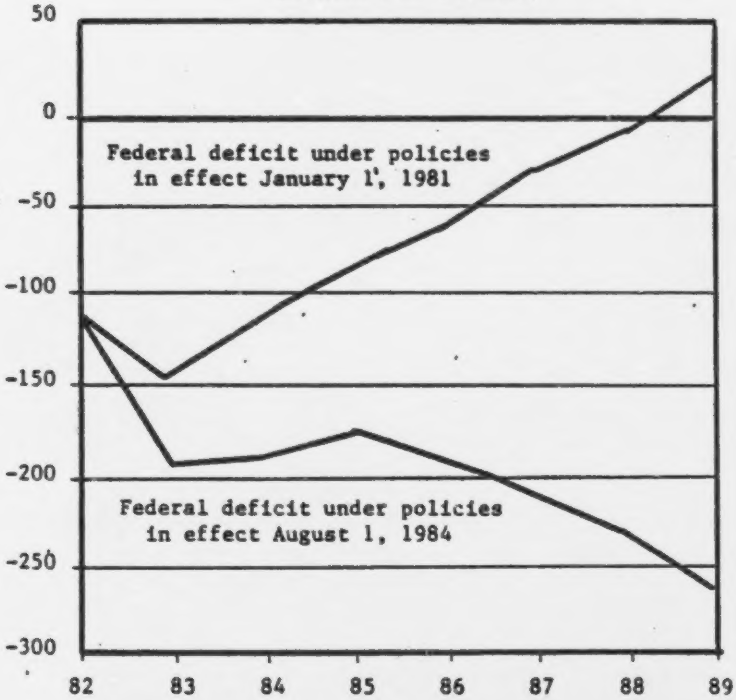
It is important to recognize the implications of omitting the possibility of a recession from budget projects. An economic downturn in the next 18 months, which we believe is quite possible, would send the deficit into the $250 billion to $300 billion range for 1986 to 1989 (see Figure 1). A recession-induced increase in the deficit would add an additional cyclical element to what are already projected to be large structural deficits (the structural deficit is the deficit that would exist if the economy were at high or full employment). It would also add to the structural deficit because the rise in government debt caused by the larger deficits associated with a recession would lead to additional interest costs that would not disappear as the economy recovers.

It is also important to realize that more than one-half of the deficit is currently supported by an unprecedented inflow of foreign capital. Whenever the foreign capital inflow shrinks or there occurs a net outflow of foreign capital (one of which is highly likely in the next 18 months), the full effect of the deficit on investment and the economy will greatly intensify.

We are very discouraged that tax and spending policies since 1981 have significantly increased the federal deficit. It took us nearly 200 years to amass a one trillion dollar debt. According to CBO estimates, policy changes made during 1981, 1982, 1983 and 1984 will add a second trillion dollars to the national debt by 1989. This represents an increase in the Federal debt of another one trillion dollars in only eight years. Policy must be changed. If it is not, $15,000 of debt will be added over the next five years in the name of each American family of four.

FIGURE 3

EFFECTS OF POLICY CHANGES SINCE
1981 ON BUDGET DEFICITS
(Billions of Dollars)



Source: Budget projections from the Congressional Budget Office, The Economic and Budget Outlook: An Update, August 1984. Adjusted by the NATIONAL ASSOCIATION OF REALTORS® to include the impact of deficit-reduction actions after August 1984.

Huge budget deficits have serious economic consequences.

Deficits cause long-term interest rates to be much higher than they would be otherwise. Deficits increase government borrowing needs which increases the total demand for loanable funds (current crowding-out), increases fears of future inflation (future crowding-out), and causes a more restrictive monetary policy than otherwise. It turns out that federal deficits are causing over one-half of the current long-term interest rate.

FIGURE 4.—CURRENT CAUSE OF HIGH MORTGAGE INTEREST RATES

[Third quarter 1984]

	Percentage points	Percent of total
Fiscal policy—deficit	7.8	57
Current crowding out	1.1	8
Inflation fears—future crowding out	6.7	49
Monetary policy	6.0	43

FIGURE 4.—CURRENT CAUSE OF HIGH MORTGAGE INTEREST RATES—Continued

[Third quarter 1984]

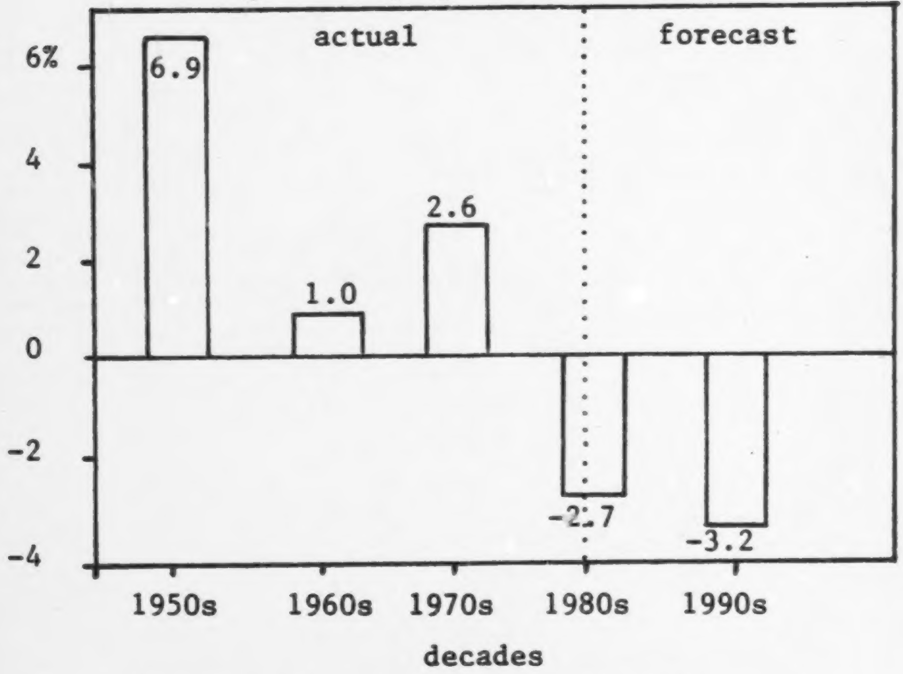
	Percentage points	Percent of total
Money growth:		
Average 1970–79	4.2	30
Current tight monetary policy required by loose fiscal policy	1.8	13
Actual interest rate	13.8	100

Source: Based on testimony of Jack Carlson before the Joint Economic Committee of the U.S. Congress debating Treasury Secretary Donald Regan's statements on "The Relationship Between Federal Deficits and Interest Rates", October 21, 1983. The estimates are based on an extension and update of several empirical studies beyond those provided by Martin Feldstein and Otto Eckstein in "The Fundamental Determinants of the Interest Rate, "The Review of Economics and Statistics," November 1970, pp. 363–375. Updated to reflect the latest actual quarterly interest rates.

Deficit-induced high interest rates have severe effects on homeownership. The Census Bureau has reported an alarming trend—the rate of homeownership in the United States has been on the decline in the last three years, the first drop since the 1930s. In 1980, 65.8 percent of the nation's households owned their home, but that figure stood at only 64.7 percent in 1983. By the year 2000, the homeownership rate could be below 60 percent if the trend of the early 1980s were to continue.

FIGURE 5

CHANGE IN THE HOMEOWNERSHIP RATE
(percentage points by decade)



* Forecast based on 1980-83 trend and other factors considered relevant by the Census Bureau.

Source: U.S. Bureau of the Census.

Families in every state have been frustrated by deficit-caused high interest rates. Based on trends prior to 1980, we would have expected the national homeowership rate to be about 67 percent by now. Each one-tenth of a percentage point decline in the homeownership rate represents about 85,000 fewer homeowners nationwide. Since 1980 almost two million households who were expected to be homeowners by now are renting and living in someone else's house. The reduction in the number of homeowners has effected every state.

FIGURE 6.—REDUCTION IN THE NUMBER OF HOMEOWNERS FROM 1980 THROUGH 1983, BY STATE

State	Actual homeowners	Expected homeowners	Number lost
Alabama	990,000	1,025,000	−35,000
Alaska	87,000	90,000	−3,000
Arizona	713,000	738,000	−25,000
Arkansas	610,000	632,000	−21,000
California	5,020,000	5,196,000	−176,000
Colorado	735,000	761,000	−26,000
Connecticut	712,000	737,000	−25,000

FIGURE 6.—REDUCTION IN THE NUMBER OF HOMEOWNERS FROM 1980 THROUGH 1983, BY STATE—Continued

State	Actual homeowners	Expected homeowners	Number lost
Delaware	155,000	160,000	−5,000
District of Columbia	96,000	99,000	−3,000
Florida	2,846,000	2,945,000	−99,000
Georgia	1,275,000	1,319,000	−45,000
Hawaii	167,000	173,000	−6,000
Idaho	252,000	261,000	−9,000
Illinois	2,624,000	2,715,000	−92,000
Indiana	1,442,000	1,492,000	−50,000
Iowa	784,000	811,000	−27,000
Kansas	650,000	673,000	−23,000
Kentucky	924,000	956,000	−32,000
Louisiana	980,000	1,015,000	−34,000
Maine	295,000	306,000	−11,000
Maryland	936,000	969,000	−33,000
Massachusetts	1,199,000	1,241,000	−42,000
Michigan	2,443,000	2,529,000	−86,000
Minnesota	1,068,000	1,106,000	−37,000
Mississippi	626,000	648,000	−22,000
Missouri	1,330,000	1,377,000	−47,000
Montana	210,000	218,000	−7,000
Nebraska	412,000	427,000	−14,000
Nevada	196,000	203,000	−7,000
New Hampshire	230,000	238,000	−8,000
New Jersey	1,624,000	1,681,000	−57,000
New Mexico	327,000	338,000	−11,000
New York	3,174,000	3,285,000	−111,000
North Carolina	1,481,000	1,533,000	−52,000
North Dakota	169,000	175,000	−6,000
Ohio	2,716,000	2,811,000	−95,000
Oklahoma	847,000	876,000	−29,000
Oregon	680,000	703,000	−24,000
Pennsylvania	3,072,000	3,179,000	−108,000
Rhode Island	208,000	215,000	−7,000
South Carolina	768,000	795,000	−27,000
South Dakota	182,000	189,000	−6,000
Tennessee	1,160,000	1,201,000	−41,000
Texas	3,434,000	3,555,000	−120,000
Utah	331,000	343,000	−12,000
Vermont	131,000	136,000	−5,000
Virginia	1,278,000	1,322,000	−45,000
Washington	1,055,000	1,092,000	−37,000
West Virginia	528,000	547,000	−18,000
Wisconsin	1,166,000	1,207,000	−41,000
Wyoming	123,000	127,000	−4,000
United States	54,463,000	56,369,000	−1,906,000

Source: National Association of Realtors, Economics and Research Division. Data from the Bureau of the Census, Census of Housing 1980; and Current Population Reports, Household and Family Characteristics: March 1983, Series P-20, No. 388.

Deficits weaken long-term growth by "crowding out" the private sector from the capital markets. In 1983, the government deficit in the United States was taking almost 70 percent of net private domestic savings. Consequently, real long-term interest rates in the U.S. were significantly higher when compared with other major industrial countries.

FIGURE 7.—GENERAL GOVERNMENT DEFICITS AS A PERCENTAGE OF GROSS NATIONAL PRODUCT AND NET PRIVATE SAVINGS AND RESULTING REAL INTEREST RATES IN 1983

	General Government [1] deficit as a percent of GNP	General Government [2] deficit as a percent of net private savings	Real long-term [3] interest rates
United States	4.1	67.8	8.6
United Kingdom	2.7	54.8	7.2
Canada	5.7	49.6	6.6
France	3.4	47.0	6.3
West Germany	3.1	37.3	5.3
Japan	3.4	28.3	4.3

[1] General government deficit includes deficits or surpluses of all government jurisdictions in a country.

[2] Net private savings is defined as household savings plus gross savings of business enterprises, subtracting depreciation charges and other capital consumption allowances.

[3] Computed assuming the rate of growth of the money supply is equal in all countries.

Source: National Association of Realtors®. Based on data from the Organization for Economic Co-operation and Development (OECD), "OECD Economic Outlook," December 1983.

Because deficits have caused real interest rates to increase at unprecedented rates since 1980, investment in people (education and training), in structures (residential, commercial, industrial and agricultural), in long-life equipment and in homeownership has suffered. Net domestic investment as a percentage of net national product has been for the last several years well below the three previous decades, and well below the needs of an expanding economy. Even with the strong recovery in 1984, investment remains below the levels of previous decades.

FIGURE 8.—SAVING AND INVESTMENT AS A SHARE OF GROSS NATIONAL PRODUCT [GNP] AND NET NATIONAL PRODUCT [NNP], SELECTED PERIODS, 1951–84

	1951–60	1961–70	1971–80	1981–84	1981	1982	1983	1984[1]
Savings and investment as a percent of GNP								
Gross national savings	15.8	15.9	16.1	14.6	16.3	13.3	13.2	15.1
Private	16.2	16.3	17.1	17.5	17.2	17.1	17.3	18.2
Federal Government	−0.2	−0.5	−1.9	−4.2	−2.1	−4.8	−5.4	−4.6
State and local government	−0.2	0.1	0.9	1.3	1.3	1.1	1.3	1.5
Plus: Net foreign capital inflow	−0.3	−0.5	0.0	0.8	0.1	0.2	1.1	2.3
Equals: Gross domestic investment	15.6	15.4	16.1	15.4	16.4	13.5	14.3	17.4
Nonresidential	10.4	11.1	11.5	11.7	12.8	10.5	10.3	13.2
Residential	5.2	4.3	4.6	3.7	3.5	3.0	4.0	4.2
Savings and investment as a percent of NNP								
Net national saving [2]	7.6	8.1	6.9	3.6	5.8	1.8	2.1	4.6
Private	8.0	8.6	8.0	6.9	6.8	6.1	6.6	8.1
Federal Government	−0.2	−0.6	−2.1	−4.8	−2.4	−5.5	−6.1	−5.2
State and local government	−0.2	0.1	1.1	1.5	1.4	1.2	1.5	1.7
Plus: Net foreign capital inflow	−0.3	−0.5	0.0	1.0	0.1	0.3	1.1	2.6
Equals: Net domestic investment [2]	7.3	7.6	6.9	4.6	5.9	2.1	3.2	7.2

[1] 1984 estimated, based upon 3 quarters of actual data and 1 quarter forecast.

[2] Net saving and investment equals the gross flow minus capital-consumption allowances (the depreciation of existing capital). Net national product equals gross national product minus capital-consumption allowances.

Source: Actual data from the U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business; 1984 forecast by the National Association of Realtors® using the Data Resources, Inc. model of the U.S. economy.

During the current recovery, deficit-caused high real interest rates and recent government tax policies have had a more severe impact on investment in structures (residential, commercial, industrial and agricultural) and a less severe impact on long-life equipment. The growth of residential investment has not been sufficient to reverse the decline of residential investment as a percentage of gross national product. Similarly, while the Accelerated Cost Recovery System enacted in 1981 has contributed to the rise of nonresidential investment as a share of GNP, it is clear that virtually all of that increase is due to the sharp increase in long-life equipment and that nonresidential structures have barely gone up.

FIGURE 9.—RESIDENTIAL AND NONRESIDENTIAL INVESTMENT IN THE CURRENT RECOVERY AND THE FIVE PREVIOUS RECOVERIES

	Percent change [1] first six quarters of recovery		Average percent of GNP during first six quarters of recovery	
	Current [2] recovery	Average [3] of five preceding recoveries	Current [2] recovery	Average [3] of five preceding recoveries
Employment	4.1	2.4		
Household income	4.4	3.5	83.0	79.8
Consumption	5.9	5.3	64.9	61.4
Gross fixed private domestic investment:				
Residential	30.5	17.0	4.0	5.0
Nonresidential	16.4	6.2	10.9	9.3
Structures	6.3	2.6	4.0	3.8
Equipment	21.0	8.8	6.9	5.6

[1] All dollar figures measured in real or inflation-adjusted terms.
[2] Current recovery 82:4 to 84:2.
[3] Five preceding recoveries: 75:1 to 76:3, 70:4 to 72:2, 60:4 to 62:2, 58:1 to 59:3, and 54:2 to 55:4.

Source: National Association of Realtors®.

Because the deficit is projected to be in the $200 to $300 billion range for the rest of the 1980 decade under current policy, savings and investment are forecast to grow very slowly. Even this projection may be optimistic, however, because it assumes (1) no recession; and (2) that the inflow of foreign capital will stay between one and two percentage points of GNP, a figure much higher than the experience prior to 1983. When capital inflow from abroad begins to shrink, the "crowding out" effect of the deficit on domestic investment will become even more critical. Without foreign capital inflow during the current recovery, the rate of investment in the United States could have been 30 to 40 percent lower in 1983 and 1984.

FIGURE 10.—SAVING AND INVESTMENT AS A SHARE OF GROSS NATIONAL PRODUCT (GNP) AND NET NATIONAL PRODUCT [NNP], FORECAST, 1984–89

	1984	1985	1986	1987	1988	1989
Savings and investment as a percent of GNP						
Gross national savings	15.1	13.9	13.3	13.4	13.7	14.0
Private	18.2	17.3	16.9	17.1	17.1	16.9
Federal Government	−4.6	−4.8	−4.9	−5.1	−4.8	−4.3
State and local government	1.5	1.4	1.3	1.4	1.4	1.4
Plus: Net foreign capital inflow	2.3	1.6	1.3	1.1	1.0	1.0
Equals: Gross domestic investment	17.4	15.5	14.6	14.5	14.7	15.0
Nonresidential	13.2	11.6	10.9	10.6	10.7	10.9
Residential	4.2	3.9	3.7	3.9	4.0	4.1
Savings and investment as a percent of NNP						
Net national saving [1]	4.6	3.5	2.9	3.0	3.4	3.6
Private	8.1	7.3	6.9	7.1	7.1	6.9
Federal Government	−5.2	−5.4	−5.5	−5.7	−5.3	−4.9
State and local government	1.7	1.6	1.5	1.6	1.6	1.6
Plus: Net foreign capital inflow	2.6	1.7	1.4	1.1	1.1	1.0
Equals: Net domestic investment [1]	7.2	5.2	4.3	4.1	4.5	4.6

[1] Net saving and investment equals the gross flow minus capital-consumption allowances (the depreciation of existing capital). Net national product equals gross national product minus capital-consumption allowances.

Source: National Association of Realtors®. Forecast based on a simulation of the Data Resources, Inc. model of the U.S. economy.

Fiscal and tax policy must impose and provide more incentives for savings and investment if the United States is to continue to be competitive in world markets.

Compared with the largest industrialized countries, gross fixed capital formation and gross savings as a percentage of national output are lowest in the United States (along with the United Kingdom).

FIGURE 11.—GROSS FIXED CAPITAL FORMATION AND GROSS SAVINGS AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT, SELECTED COUNTRIES, 1962 to 1983

	1962–69	1970–79	1980	1981	1982	1983
Gross Fixed Capital Formation as a Percentage of GDP:						
United States	18.2	18.4	18.5	17.9	16.6	17.4
Japan	32.2	33.2	32.0	31.0	29.9	29.1
West Germany	24.8	22.6	22.8	21.9	20.5	20.9
France	23.0	23.1	21.7	21.1	20.5	20.0
United Kingdom	18.0	18.7	17.4	15.7	15.4	15.8
Italy	21.1	18.1	19.8	20.2	19.0	18.2
Canada	22.1	22.4	22.8	23.5	21.1	21.0
Average	20.6	21.7	21.8	21.1	19.8	20.0
Gross Savings as a Percentage of GDP:						
United States	19.8	19.0	18.3	19.1	15.9	NA
Japan	34.1	35.3	31.9	31.7	30.8	NA
West Germany	27.0	24.4	22.3	21.0	21.5	NA
France	25.0	24.2	22.0	19.7	18.5	NA
United Kingdom	18.6	18.7	18.8	17.3	16.9	NA
Italy	23.8	22.3	22.5	19.0	18.8	NA
Canada	22.3	21.6	22.5	22.6	19.0	NA
Average	22.2	22.7	21.9	21.6	19.5	NA

Source: Organization for Economic Co-operation and Development (OECD), OECD Economic Outlook, July 1984. Gross savings is the sum of national disposable income and consumption of fixed capital less consumption expenditure of households and government. It is the surplus available from current transactions to finance gross capital formation and capital transactions with the rest of the world.

Deficit-caused high real interest rates over-value the U.S. dollar, thus crippling U.S. export industries (e.g. grain and aerospace) and damaging U.S. industries which compete with imports (e.g. steel and automobiles).

High U.S. interest rates attract foreign capital which helps finance the deficit. But this offset is at a high cost. The inflow of foreign funds has increased the exchange value of the U.S. dollar by 15 to 25 percent. This acts like a tax on U.S. export industries, reducing the quantity of American-made products and services sold abroad. Similarly, it acts like a subsidy on foreign-made products and services coming into the U.S., damaging U.S. industries which must compete with imports and inhibiting investment in new and promising businesses.

Because of high federal budget deficits, we have experienced record balance of payments deficits with a resulting decline in American jobs. According to the U.S. Department of Commerce, the 18.9 percent drop in U.S. export volume between 1980 and 1983 has already produced a huge loss of 1.5 million jobs.[1] The Commerce Department has estimated that an average of 25,000 jobs are lost for each one billion dollar decline in export volume. Thus, under current budget deficit projections and the resulting high real interest rates deficits cause, the projected shortfall in export volume of $100 billion will cause an additional loss of 2.5 million jobs from 1984 to 1986, making a total loss of 4 million jobs from 1981 through 1986.

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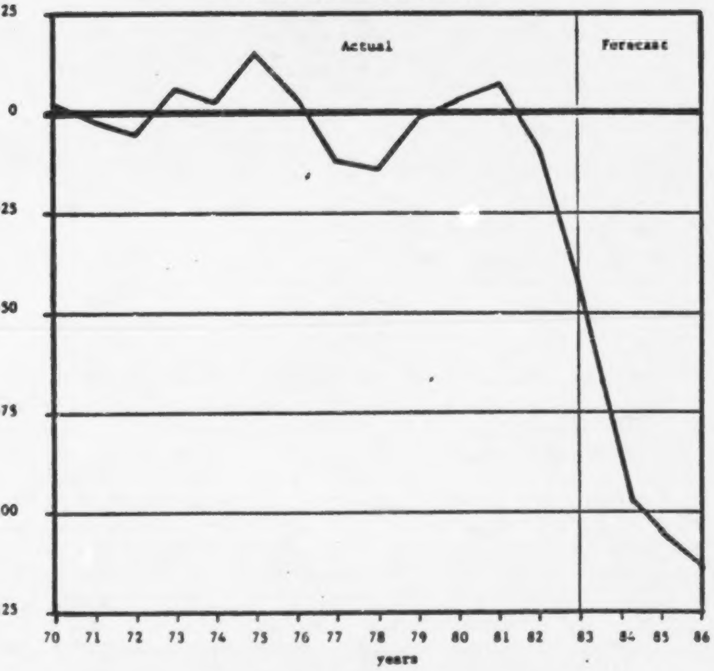
[1] See U.S. Department of Commerce, Office of Trade and Investment Analysis, "*U.S. Trade Performance in 1983 and Outlook*," June 1984.

FIGURE 12

U.S. EXPORTS AND IMPORTS OF GOODS AND
SERVICES, CURRENT ACCOUNT BALANCE
(Billions of Dollars)



Source: NATIONAL ASSOCIATION OF REALTORS®. Forecast based on a simulation of the Data Resources, Inc., macroeconomic model of the U.S. economy.

A BIPARTISAN PROGRAM TO REDUCE THE FEDERAL DEFICIT

Decisive leadership and action to reduce projected federal deficits is needed now. There may never be a better opportunity to solve the deficit problem. The current recovery should not distract the Congress or the President from confronting the long-term structural deficit early in 1985. The recovery provides an ideal climate for making tough but necessary spending reductions and tax change.

We are not encouraged by the deficit-reduction actions adopted by the Congress and the President (through September 28, 1984); nor are we encouraged by the deficit-reduction actions proposed by Democratic presidential candidate Walter Mondale. Both deficit-reduction actions are likely to discourage savings and investment resulting in slower economic growth. Both actions support a large proportion of tax increases. Both actions support especially large tax increases on investment which will and would reduce timely investment in homes, work places, shopping areas and homeownership.

The $68 billion deficit-reduction actions so far in 1984 are 73 percent tax increases and only 27 percent spending reductions (see Figure 13). Moreover, a significant portion of the 1984 tax increases rely more heavily on investment (see Figure 21).

Similarly, the actions proposed in the $109 billion additional deficit-reduction program by former Vice President Mondale are 78 percent tax increase and only 22 percent spending reductions. Most of the additional taxes proposed by the former Vice President would discourage investment.

FIGURE 13.—COMPARISON OF SPENDING VERSUS TAX EMPHASIS IN DEFICIT-REDUCTION ACTIONS ADOPTED BY PRESIDENT REAGAN AND PROPOSED BY FORMER VICE PRESIDENT MONDALE DURING 1984

[Dollars in billions]

	Actual 1984 deficit-reduction actions by the Congress and by President Reagan	Percent	Proposal by former Vice President Mondale for further action	Percent
Tax increases (excluding receipts from higher growth assumptions)	$50	73	$85	78
Spending reduction action (excluding interest rate impact on federal deficit)	$18	27	$24	22
Total deficit reduction (excluding interest rate impact on federal deficit and changes in growth assumptions)	$68	100	$109	100

Source: Based on (1) the deficit-reduction actions passed by the Congress and signed by President Reagan in 1984; and (2) the Mondale campaign announcement on September 10, 1984. Analysis by the National Association of Realtors®.

Heavy reliance on tax increases on investment to balance the budget will discourage investment in people, structures, long-life equipment and homeownership, will lead to higher inflation, lower economic growth, and will keep the American standard of living and quality of life at a lower level.

The NATIONAL ASSOCIATION OF REALTORS® has a long history of expressing concern to the Congress and the President about the negative impact of federal deficits on the economy and of advocating the importance of increasing investment to raise the long-term growth prospects of the economy. As a continuation of this effort, we have recently joined with the bipartisan group of former Secretaries of Treasury and Commerce, with 500 business leaders, and with 32 other professional organizations to form the Bipartisan Budget Coalition (see Figure 14).

We are united behind three basic principles which were published on September 10, 1984:

1. Long term focus.—Reforms must be large, structural, and permanent—in keeping with the size and duration of the problem. One-shot actions are not enough.

2. Fairness and burden sharing.—Wide and fair sharing of reductions is essential, while the poor must be protected.

3. Focus on investment and savings.—The objective should be to increase savings and investment. Cutting deficits by measures that would at the same time reduce savings and productive investment would make no long-term sense.

We strongly recommend the following program to reduce federal budget deficits and to encourage greater savings and investment. This program has also been endorsed by all other members of the Coalition.

1. A freeze of at least one year—preferably two—in cost-of-living adjustments (COLAs) for the large, non-means tested spending program;
2. A cap on future indexing of spending programs and of personal income tax brackets (e.g., at 60 percent of the Consumer Price Index (CPI) or at 2 to 3 percentage points less than the CPI);
3. Similar restraints on all other transfers, subsidies, and programs beyond those for means-tested programs;
4. A multi-year defense buildup at a more moderate pace (real growth of no more than 3 to 5 percent); and
5. Once spending cuts of the type and magnitude described above are assured, any revenue measures needed to reach the deficit reduction goal should mainly rely on consumption-oriented taxes in order to avoid weakening incentives to work, save, and invest. However, any tax increases should be tied to and exceeded by spending cuts.

FIGURE 14

THE BIPARTISAN BUDGET COALITION

The Bipartisan Budget Appeal, an organization of over 600 former public officials and heads of law firms, investment banks, accounting firms, major corporations, universities, foundations, and other organizations. Founding Members of the Bipartisan Budget Appeal are:

The Hon. W. Michael Blumenthal
Secretary of the Treasury, 1977-79
The Hon. John B. Connally
Secretary of the Treasury, 1971-72
The Hon. C. Douglas Dillon
Secretary of the Treasury, 1961-65
The Hon. Henry H. Fowler
Secretary of the Treasury, 1965-68
The Hon. Peter G. Peterson
Secretary of Commerce, 1972-73
The Hon. William E. Simon
Secretary of the Treasury, 1974-76

The National Independent Dairy-Food Association, independent dairy processors of fluid milk and milk products.

Menswear Retailers of America, an organization of 9,000 retailers of men's and boy's clothing and furnishings.

The United States League of Savings Institutions, an organization of 3,500 savings and loan associations, savings banks, and cooperative banks, with combined assets of more than $900 billion.

The Small Business Legislative Council, a coalition of 84 national trade and professional associations whose membership consists primarily of small businesses.

Automotive Service Councils, Inc., an organization of 6,000 independent automotive repair shops including body, paint and service centers.

The Dealer Bank Association, a nonprofit organization of commercial banks which, through "dealer" divisions or departments underwrite, trade, or deal in a variety of public securities including federal, state and local government securities, money market instruments and foreign exchange.

The Retail Floorcovering Institute, an organization of 2,000 specialty floor covering retailers.

The American Bankers Association, an organization of 13,000 commercial bank and trust companies with combined assets of $1.9 trillion.

The American League of Financial Institutions, a trade association consisting of 75 Black, Hispanic, Asian-American and women's savings institutions with total assets in excess of $3.8 billion.

The National Small Business Association, an organization of 50,000 firms representing more than 500 kinds of business.

The Mortgage Insurance Companies of America, an organization representing the mortgage insurance industry, with members having over $175 billion of insurance in force on homeowners' mortgages made more affordable with low downpayment financing.

The Independent Media Producers Association, an organization representing individuals and firms engaged in producing audiovisual presentations.

The National Association of Realtors, a federation of 50 state associations of Realtors and 1,848 local real estate boards with 637,000 Realtors and Realtor-associates.

The Manufactured Housing Institute, the national trade association of manufactured home builders and their supplier companies, whose members produce 75% of the manufactured homes in the United States.

The National Association of Retail Druggists, an organization representing 30,000 independent retail pharmacists.

The American Land Title Association, a national trade association of the land title industry with approximately 2,000 members whose principal function is to insure the safe and efficient transfer of residential and commercial real estate.

The Specialty Advertising Association International, an association of suppliers, distributors and direct selling houses of specialty advertising.

The Mortgage Bankers Association of America, an association with 2,100 members, principally mortgage banking firms, commercial banks, savings institutions, and insurance companies which engage in the mortgage banking business.

The Independent Bankers Association of America, an association of 7,500 community banks across the United States.

The National Grange, the 117 year-old fraternal organization of rural families, promoting agriculture and numbering 425,000 members.

The National Association of Surety Bond Producers, an association with 430 members, principally insurance agents and brokers writing contract surety bonds.

The American Consulting Engineers Council, an association with 3,900 members, prinicipally consulting engineering firms engaged in private practice.

The National Council of Savings Institutions, an association of 600 savings banks and savings and loan associations with over $400 billion in assets.

The Brick Institute of America, an association of over one hundred brick manufacturers representing eighty percent of the total brick production of the United States.

The American Institute of Architects, the 127 year-old professional association representing the nation's architects, with 43,000 members.

The National Association of Casualty and Surety Agents, an association with 305 members, principally agents handling fire, casualty and surety insurance.

United Bus Owners of America, individuals, firms and corporations actively engaged in the bus industry, especially those in intercity or interstate operations.

The National Association of Home Builders of the United States, an organization of 124,000 single and multi-family home builders, commercial builders, remodelers, architects, sub-contractors, and others associated with the building industry.

The National Forest Products Association, an association representing the forest products industry on national issues concerning the growing of timber and the manufacture, distribution, marketing and use of wood products.

The National Association for the Self-Employed, an organization of 350,000 self-employed and small independent businesspersons.

The American Bus Association, an organization of 3,000 privately-owned bus operating firms.

The National Association of Brick Distributors, distributors and dealers of structural clay products.

To contact the Bipartisan Budget Coalition, write to P.O. Box 5203, F.D.R. Station, New York, NY 10150.

THE BIPARTISAN
BUDGET COALITION
DOWN
WITH THE
DEFICIT

Enactment of the bipartisan deficit-reduction action described above will increase tax revenues and reduce government spending by almost equal amounts ($85 billion in tax increases and $100 billion in spending cuts by 1989). This action will reduce the federal deficit by $185 billion by the end of the deacade, from an expected $249 billion to $64 billion. This action will reduce the deficit as a percentage of net domestic savings to slightly more than 17 percent from a projected level of almost 70 percent.

FIGURE 15.—REDUCTIONS IN THE DEFICIT FROM THE BIPARTISAN BUDGET COALITION DEFICIT REDUCTION PROGRAM

[NIA basis, billions of dollars]

	1986	1988	1989
Expected deficit	−210	−228	−249
Impact on revenues	12	45	85
Direct	1	15	40
Induced	11	30	45
Impact on expenditures	−19	−45	−100
Transfer payments	−10	−14	−37
Direct	9	12	26
Induced	−1	−2	−11
Net interest	−9	−31	−63
Reduction in deficit	−31	−90	−185
Resulting deficit	−179	−138	−64
Percent of GNP	4.3	2.8	1.2
Percent of net domestic savings	55.2	38.2	17.2

Source: National Association of Realtors®. Based on simulation of the Data Resources, Inc. long-term macroeconomic model of the U.S. economy.

The bipartisan deficit-reduction action will lead to greater savings by individuals and greater investment by industry. Less government borrowing will allow real long-term interest rates to decline by more than one percentage point in the first year and by more than three percentage points within a few years. As a result, residential investment would likely increase 47 percent and nonresidential investment would increase 11 percent. A small concession by most would result in greater benefits for all in the years ahead. Other economic benefits are shown in Figure 16 for the nation and in Figure 17 for each state.

FIGURE 16.—ECONOMIC IMPACT OF THE BIPARTISAN BUDGET COALITION DEFICIT REDUCTION PROGRAM WITHIN 5 YEARS

Long-term interest rates	3 percentage points lower
Residential investment	47 percent higher
Nonresidential investment	11 percent higher
Income per household	$1,800 higher
Total private savings	4 percentage points higher
Housing starts	650,000 increase
Existing home sales	1,200,000 increase
Domestic car sales	1,500,000 increase
Homeownership rate	2.5 percentage points higher
Employment	2.2 million more jobs.

FIGURE 17.—ECONOMIC IMPACT OF THE BIPARTISAN BUDGET COALITION DEFICIT REDUCTION PROGRAM WHEN FULLY IMPLEMENTED, BY STATE

State	Increase in permanent jobs	Increase in income per household (annual)	Households satisfying new and existing home needs
Alabama	42,600	1,300	25,400
Alaska	6,300	2,300	8,400

FIGURE 17.—ECONOMIC IMPACT OF THE BIPARTISAN BUDGET COALITION DEFICIT REDUCTION PROGRAM WHEN FULLY IMPLEMENTED, BY STATE—Continued

State	Increase in permanent jobs	Increase in income per household (annual)	Households satisfying new and existing home needs
Arizona	20,600	1,500	33,200
Arkansas	20,400	1,300	23,200
California	201,500	1,900	141,300
Colorado	23,000	1,800	20,600
Connecticut	36,400	2,100	14,800
Delaware	4,900	1,900	5,700
District of Columbia	3,200	2,200	3,600
Florida	65,400	1,600	101,300
Georgia	44,500	1,400	50,200
Hawaii	4,800	1,800	4,400
Idaho	8,800	1,400	6,500
Illinois	89,500	1,900	61,900
Indiana	65,400	1,600	29,800
Iowa	21,000	1,600	22,700
Kansas	22,100	1,800	24,600
Kentucky	30,800	1,400	29,000
Louisiana	34,000	1,600	50,400
Maine	9,400	1,400	9,800
Maryland	30,500	1,800	44,600
Massachusetts	42,800	1,800	29,000
Michigan	119,300	1,700	68,800
Minnesota	35,600	1,700	42,800
Mississippi	23,300	1,200	23,500
Missouri	39,600	1,600	32,800
Montana	6,400	1,600	5,600
Nebraska	11,100	1,600	16,600
Nevada	4,500	1,800	8,000
New Hampshire	8,700	1,600	6,600
New Jersey	51,700	1,900	77,800
New Mexico	9,700	1,400	13,300
New York	102,100	1,900	63,200
North Carolina	69,000	1,400	77,600
North Dakota	3,900	1,600	6,700
Ohio	125,600	1,700	62,300
Oklahoma	22,600	1,700	51,900
Oregon	34,400	1,600	17,300
Pennsylvania	108,800	1,600	68,100
Rhode Island	7,100	1,700	3,900
South Carolina	33,800	1,300	28,100
South Dakota	3,500	1,300	8,200
Tennessee	44,700	1,400	37,800
Texas	130,100	1,800	144,300
Utah	11,900	1,300	10,300
Vermont	4,600	1,400	5,700
Virginia	47,900	1,700	67,700
Washington	48,400	1,800	27,800
West Virginia	13,900	1,400	14,600
Wisconsin	44,500	1,600	26,500
Wyoming	5,500	1,800	5,700
United States	2,200,000	1,800	1,850,000

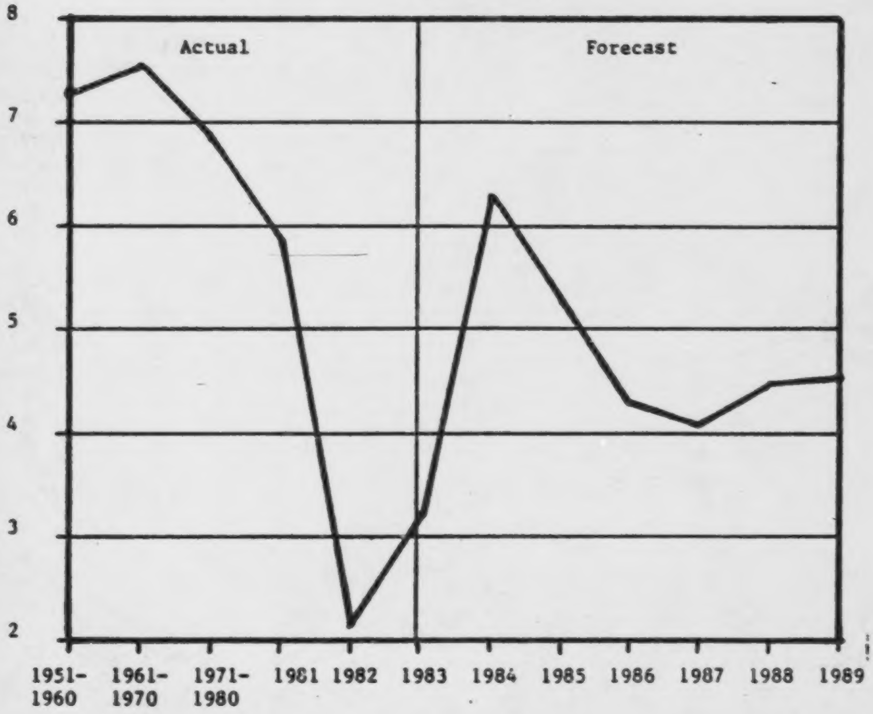
Source: Model developed by the National Association of Realtors® and Data Resources, Inc. Assumptions and simulations by Dr. Jack Carlson and Dr. Richard Peach.

TAX REFORM: THE NEED FOR MORE SAVINGS AND INVESTMENT

Tax reform should alter incentives so that the private sector is encouraged to save and invest more. The current federal tax system does not encourage enough savings and investment. Net domestic investment as a percent of net national product has declined sharply. Even with a strong recovery this year, investment remains below the levels or previous decades, and is forecast to grow slowly during the next five years under current policy.

FIGURE 18

NET DOMESTIC INVESTMENT AS A SHARE
OF NET NATIONAL PRODUCT
(percent)



a/ Net domestic investment equals private savings plus government savings plus net foreign capital inflow minus capital consumption allowances. Net national product equals gross national product minus capital consumption allowances.

Source: Actual data from the U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business: Forecast by the NATIONAL ASSOCIATION OF REALTORS® using the Data Resources, Inc. macroeconomic model of the U.S. economy.

Federal deficits are overwhelming the modest but important gains in private savings and investment due to modest recent tax reform. Recent changes in tax law—notably the Economic Recovery Tax Act of 1981—encouraged to a modest extent more savings and investment. But overall, the proportion of tax changes that went to savings and investment were smaller than changes over the preceding 20 years. The small pro-savings gains achieved have been more than offset by huge increases in federal budget deficits. This year the federal deficit is taking more than 56 percent of net domestic savings, and by the end of the decade, it is estimated that deficits will take nearly 70 percent of savings.

FIGURE 19.—EFFECTS OF POLICY CHANGES SINCE 1981 ON FEDERAL BUDGET DEFICIT PROJECTIONS

[Dollars in billions]

	Fiscal years					
	1982	1983	1984	1985	1986	1987–89
Federal deficit under policies [1]	$111	$149	$90	$73	$52	0
Federal deficit under policies in effect Aug. 1, 1984	$111	$195	$172	$178	$195	$239
Increase in federal deficit due to tax and spending policy changes made during 1981, 1982, 1983, and 1984	0	$47	$62	$93	$132	$234
Net domestic savings [2]	$211	$216	$304	$329	$325	$354
Federal deficit as a percent of net domestic savings under policies in effect Jan. 1, 1981	52.6	69.0	29.6	22.2	16.0	0
Federal deficit as a percent of net domestic savings under policies in effect Aug. 1, 1984	52.6	90.3	56.6	54.1	60.0	67.5

[1] The deficits for policies in effect in 1981 and 1984 are adjusted for revisions in the CBO projections since publication of the baseline projections in February 1984.

[2] Net domestic savings equals personal savings plus business retained earnings plus inventory valuation adjustment (corporations) plus capital consumption adjustment plus state and local government surplus.

Source: Budget projections from the Congressional Budget Office [CBO], "The Economic and Budget Outlook: An Update," August 1984; and unpublished data from the CBO. Projections of net domestic savings from the National Association of Realtors® based on a simulation of the Data Resources, Inc. model of the U.S. economy.

More recent tax legislation has eroded the modest pro-investment and pro-savings gains achieved in the Economy Recovery Tax Act of 1981 (ERTA). The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced investment incentives through a number of provisions which reduced depreciation expense and thereby increased the taxable income from investments. ERTA provided for a gradual phase in of the 200 percent declining balance and sum-of-the years digits (equipment and vehicles). TEFRA repealed this provision and kept 150 percent declining balance and straight-line as the only depreciation methods for personal property.

The initial impact of TEFRA is modest. The cumulative impact over a number of years, however, is quite substantial. Because TEFRA reduces investment and therefore the productive capacity of the economy, by 1990 real gross national product will be almost 5 percent lower, investment in long-life equipment will be $48 billion lower, commercial, industrial and agricultural investment will decline by almost 10 percent, 600,000 jobs will be lost, and household income will fall by $2,600.

FIGURE 20.—ECONOMIC IMPACT OF THE TAX EQUITY FISCAL RESPONSIBILITY ACT OF 1982 [TEFRA] BY 1990

	Dollar amount (1984 dollars)	Percent decline
Real gross national product	−$210,000,000	−4.9
Investment in producers' long-life equipment	−$48,000,000	−12.5
Investment in nonresidential structures	−$20,000,000	−9.4
Employment (jobs)	−600,000	−0.5
Income per household	−$2,600	−4.5

Source: National Association of Realtors®, based on a simulation of the Data Resources, Inc. model of the U.S. economy.

Similarly, the Tax Reform Act of 1984 (TRA) included several anti-investment provisions. Foremost among these is the lengthening to 18 years the 15 year depreciation period for depreciable real estate enacted into law in 1981 under ERTA. This change alone will reduce investment in commercial, industrial, and rental residential structures by an average of 4.8 percent each year.

FIGURE 21.—ANNUAL DECLINE IN INVESTMENT IN COMMERCIAL, INDUSTRIAL, AND RENTAL RESIDENTIAL STRUCTURES FROM EXTENSION OF COST RECOVERY PERIOD FROM 15 YEARS TO 18 YEARS ADOPTED IN THE TAX REFORM ACT OF 1984

[Dollars in billions]

	Percent decline	Dollar amount (1984 dollars)	Square footage in millions (1984 costs)
Commercial structures	4.2	$1.7	28
Industrial structures	4.0	0.3	5
Rental residential structures	5.9	1.6	39
Total	4.8	3.6	72

Source: National Association of Realtors®, based on a simulation of the Data Resources, Inc. model of the U.S. economy.

By lengthening the depreciation period and increasing the tax burden on structures, TRA results in a decline in the value of all existing structures in all the states. With the stock of commercial, industrial and rental residential structures estimated at almost $3 trillion, the loss of value of the existing stock of such structures would equal about $135 billion for the nation, the equivalent of $1,700 per household.

FIGURE 22.—DECLINE IN VALUE OF EXISTING COMMERCIAL, INDUSTRIAL, AND RENTAL RESIDENTIAL STRUCTURES RESULTING FROM EXTENSION OF COST RECOVERY PERIOD TO 18 YEARS, BY STATE

[Constant 1984 dollars]

State	Loss in the value of existing structures	Loss in household income	State	Loss in the value of existing structures	Loss in household income
Alabama	1,992,613,000	1,500	Montana	402,605,000	1,500
Alaska	332,421,000	2,400	Nebraska	900,518,000	1,700
Arizona	1,082,926,000	1,700	Nevada	640,581,000	2,300
Arkansas	1,082,926,000	1,400	New Hampshire	605,973,000	1,900
California	14,990,720,000	1,800	New Jersey	4,586,884,000	1,800
Colorado	2,023,739,000	2,000	New Mexico	724,242,000	1,600
Connecticut	2,160,471,000	2,000	New York	10,649,178,000	1,800
Delaware	393,504,000	1,900	North Carolina	3,591,076,000	1,800
Dist. of Columbia	879,785,000	2,100	North Dakota	367,403,000	1,600
Florida	5,874,125,000	1,800	Ohio	6,180,307,000	1,700
Georgia	3,403,102,000	1,800	Oklahoma	1,798,209,000	1,700
Hawaii	602,958,000	1,800	Oregon	1,418,082,000	1,600
Idaho	473,124,000	1,400	Pennsylvania	6,770,468,000	1,700
Illinois	6,745,793,000	1,700	Rhode Island	591,245,000	1,800
Indiana	3,002,687,000	1,600	South Carolina	1,779,272,000	1,700
Iowa	1,545,001,000	1,500	South Dakota	353,911,000	1,500
Kansas	1,368,321,000	1,700	Tennessee	2,516,707,000	1,600
Kentucky	1,757,118,000	1,400	Texas	9,323,572,000	1,900
Louisiana	2,379,301,000	1,600	Utah	845,466,000	1,700
Maine	621,050,000	1,600	Vermont	309,341,000	1,800
Maryland	2,513,081,000	1,700	Virginia	3,238,179,000	1,800
Massachusetts	3,928,633,000	2,000	Washington	2,325,842,000	1,600
Michicgan	4,873,644,000	1,500	West Virginia	878,405,000	1,300
Minnesota	2,563,981,000	1,800	Wisconsin	2,793,068,000	1,700
Mississippi	1,202,907,000	1,400	Wyoming	307,663,000	1,900
Missouri	2,815,482,000	1,700	United States	135,000,000,000	1,700

Source: National Association of Realtors®, based on a simulation of the Data Recources, Inc. model of the U.S. economy.

Tax reform should aim at encouraging more savings and investment and not aim at discouraging savings and investment. One of the biggest incentives for the average American to save turns out to be homeownership. A person stretches to get into a home and agrees to a monthly payment that's a very large portion of income. This encourages a person to save and initially just to invest in his or her home. As income rises and mortgage payments (as a percentage of income) dimish, the habit of saving continues and is used beyond the needs of housing, for business and for industry.

A 1977 University of Michigan study of household investments (including savings and checking accounts, stocks, bonds and real estate equity) found that homeowners in all income classes save more than renters of the same income—on average about 50 percent more. Homeownership is a great discipline for saving.

FIGURE 23.—SAVINGS AND INVESTMENT BY INCOME [1]

[1977 data]

	Renters	Homeowners			
		Including residence		Excluding residence	
	Savings dollar amount	Savings dollar amount	Percent of renters	Savings dollar amount	Percent of renters
All income groups	$16,000	$42,000	263	$24,000	150
Low income	5,000	23,000	460	12,000	240
Middle income	11,000	29,000	263	17,000	155
High income	36,000	71,000	197	42,000	117

[1] Includes savings and checking accounts, certificates of deposit, common and preferred stocks, government and corporate bonds, and equity in real estate.

Source: National Association of Realtors®. Results based on survey data from the University of Michigan, Survey Research Center, "Study of Consumer Credit," 1977.

Solving the causes of declining homeownership should be a national priority and a major objective of federal tax reform. In 1980, 65.8 percent of the nation's households owned their home, but that figure stood at only 64.7 percent in 1983. If the homeownership rate is prevented from returning to an upward path, the nation is likely to experience less savings for both residential investment, and for commercial, industrial, and agricultural investment. This would cause less growth in family incomes and employment, and higher inflation and federal deficits.

FIGURE 24.—ECONOMIC IMPACT OF A 10-PERCENTAGE POINT DECLINE [1] IN THE HOMEOWNERSHIP RATE BY THE YEAR 2000

[Annual result in 1983 dollars]

	Low estimate	Percent	High estimate	Percent
Less savings	$50,000,000,000	9.7	$100,000,000,000	19.4
Less investment in shelter	$45,000,000,000	9.3	$100,000,000,000	20.8
Less investment in industry	$55,000,000,000	3.2	$100,000,000,000	5.9
Less employment	2,000,000	1.6	4,000,000	3.2
Less household income	$1,000	2.2	$2,000	4.4
Fewer automobile sales	900,00	7.5	2,000,000	16.7
Higher Federal deficit	$135,000,000,000		$300,000,000,000	
Higher inflation (percent)	0.8		1.5	

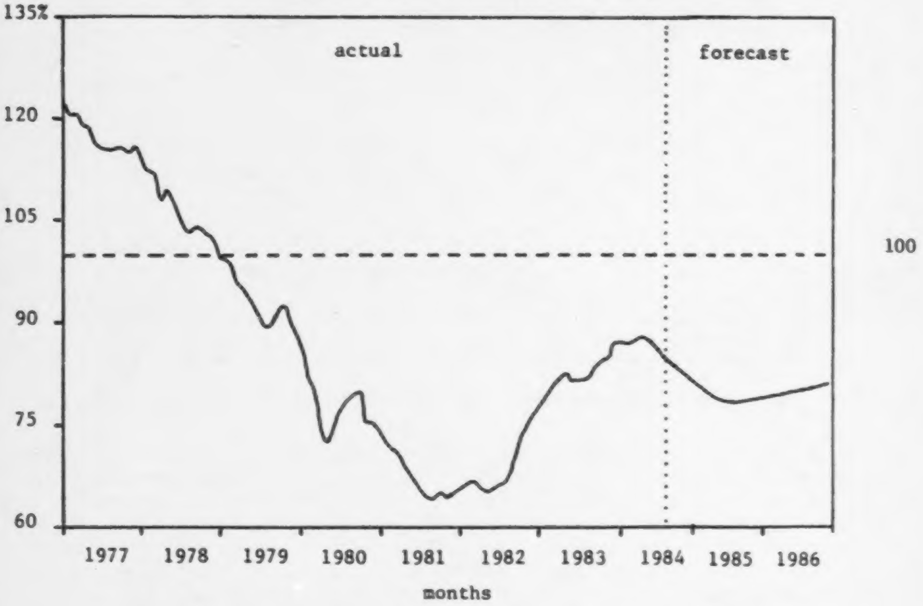
[1] It was reasonable to expect that a lower homeownership rate is associated with slower growth of employment and a decrease in work effort. The slower employment growth lowers income growth which decreases personal savings and consumption. Some research has found that two-earner households are encouraged when people are able to achieve homeownership, and the ability to acquire a home makes people 30 percent more likely to believe if one works hard one will get ahead. Other research shows that if people are unable to achieve homeownership, they no longer feel they can get ahead by working hard, and therefore work effort is reduced.

Source: National Association of Realtors®, based on a simulation of the Data Resources, Inc. annual model of the U.S. economy. See also Dowell Myers, "The Impact of Rising Homeownership Costs on Family Change", a paper prepared for the Population Association of America, April 1983; and Myers, "Growing Tensions Within the American Dream: The Homeownership Crisis and Social Change," a paper prepared for the Association of Collegiate Schools of Planning, October 1982.

The major cause of declining homeownership is not a preference for renting but a growing affordabililty crisis. Repeated surveys on what constitutes the "good life" show that homeownersship consistently ranks highest among all American households, along with a happy marriage and family. Figure 25 shows the change in the abililty of a family earning the median income to qualilfy for a mortgage on the median-priced existing home. While the index has improved substantially from its low point in 1981 to 82.9 in August (the latest month available), we expect it will remain significantly lower—in the range of 78 to 84—through 1986. (An index of 82.9 means that a family with the median income is 17.1 percent short of the income needed to qualify for a mortgage financing 80 percent of a median priced resale property).

FIGURE 25

HOUSING AFFORDABILITY INDEX 1977-86

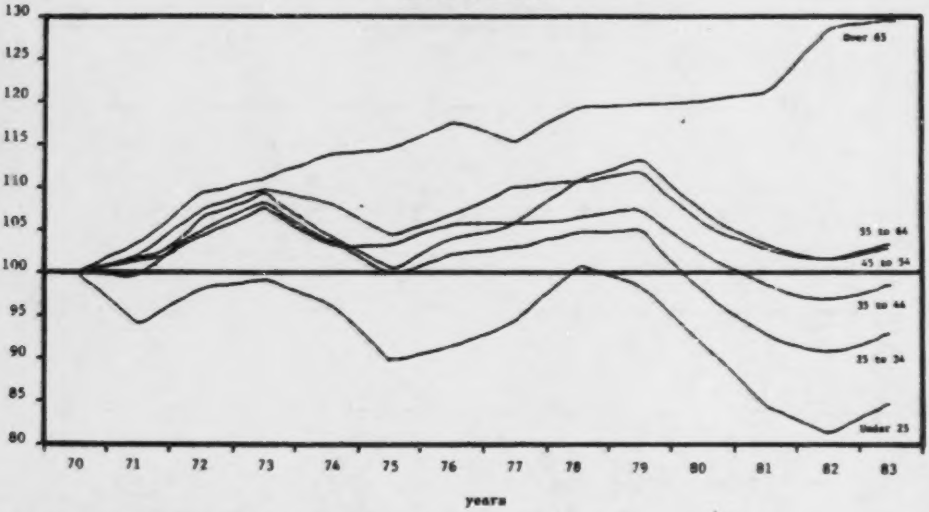


Source: Index developed by the NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division. Forecast made using the Data Resources, Inc. model of the U.S. economy.

Homeownership is declining the majority of the because 1950s baby boom generation are dramatically worse off then people their age were 10 years ago, and they are steadily falling further behind. Two thirds of the second, and largest, wave of the post World War II baby boom (those between the ages of 25 and 34) earn 5 to 10 percent less income than their predecessors who matured in the 1960s (see Figure 26). The majority of the first wave (those over the age of 35) have also suffered a slight decline in income, but the later and more numerous arrivals are facing greater economic difficulty, while those under the age of 25 have fallen behind the furthest. Even with economic recovery and the remaining and modest tax incentives encouraging homeownership, most of the households in the second wave of the baby boom will find it much more difficult to afford the kinds of homes their parents, and even their predecessors in the baby boom, were able to buy.

FIGURE 26

GROWTH IN MEDIAN FAMILY INCOME, ADJUSTED FOR INFLATION, BY AGE OF HOUSEHOLDER
(1970 = 100.0)



a/ Adjusted for inflation with the consumer price index.

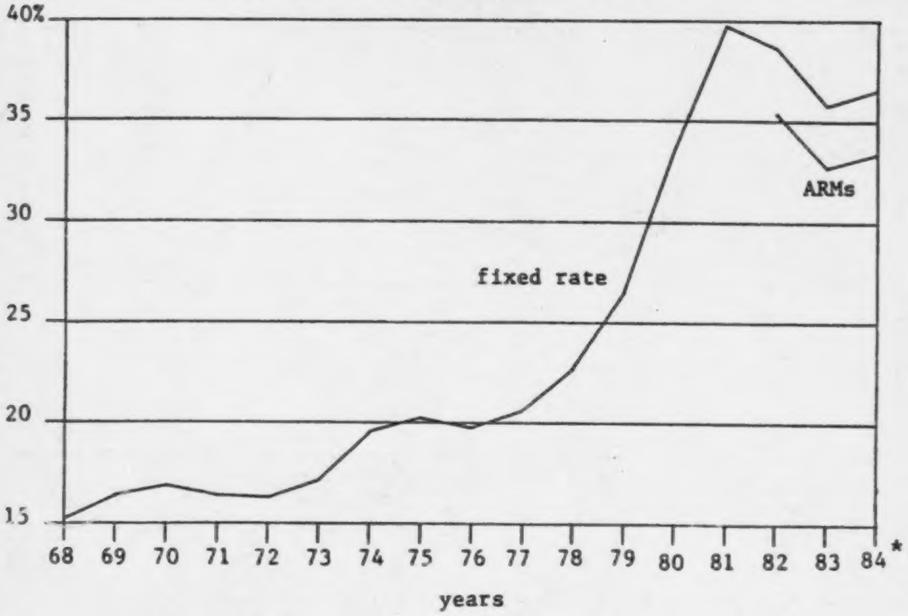
b/ 1983 estimated.

Source: NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division. Based on data from the U.S. Bureau of the Census, Current Population Reports, Series P-60, Money Income of Households, Families, and Persons in the United States, U.S. Government Printing Office, Washington, D.C., various years.

Homeownership is declining because families are using more of their income for shelter than ever before, even with innovations such as adjustable rate mortgages. Since 1980 homebuyers have had to use beetween 30 and 40 percent of family income just to make their mortgage payments.

FIGURE 27

MONTHLY MORTGAGE PAYMENT AS A PERCENTAGE OF MEDIAN FAMILY INCOME, 1968-84



* January to June.

Source: NATIONAL ASSOCIATION OF REALTORS®. Monthly mortgage payment calculated based on the effective conventional mortgage committment rate reported by the Federal Home Loan Bank Board, and 80 percent of the median price of an existing home reported by the NATIONAL ASSOCIATION OF REALTORS®. Median family income from the U.S. Bureau of the Census.

EVALUATION OF ALATERNATIVE TAX SYSTEMS

Tax reform proposals now under consideration fall into three main groups: (a) simple flat rate tax systems which would broaden the tax base by eliminating all credits, exclusions, allowances and deductions in the current law, and use one marginal tax rate for all taxpayers; (2) modified flat rate tax systems which would eliminate most credits, exclusions, allowances and deductions, and use substantially fewer marginal tax rates than current law; and (3) consumption tax systems which would replace income with consumption as the designated tax base.

Virtually all of the sponsors of these tax reform proposals claim their systems are revenue neutral, that they raise the same amount of revenue as current law. We would urge the Committee to examine carefully claims of revenue neutrality before accepting any of them. This claim is extremely difficult to substantiate, even with the use of sophisticated tax models because a tax model can only analyze what would happen in a static sense based on past experience. Even with such analysis we should recognize that no tax model can predict in a dynamic sense what changes in economic behavior might occur or what new innovations may arise in response to massive changess in the tax code.

FIGURE 28.—TAX REFORM PROPOSALS PENDING IN CONGRESS AS OF MAY 23, 1984

Bill number	Sponsor	Type of tax	Tax rate (percent)	
			Individual	Corporate
H.R. 3271	Rep. Richard Gephardt (R–WI)	Income tax	14–30	30
S. 1472	Sen. Bill Bradley (D–NJ)	do	14–30	30
H.R. 5533	Rep. Jack Kemp (R–NY)	do	25	30
S. 2600	Sen. Robert Kasten (R–WI)	do	25	30
H.R. 5432	Rep. Mark Siljander (R–MI)	do	10	([2])
H.R. 170	Rep. George Hansen (R–ID)	do	15	([2])
H.R. 542	Rep. Philip M. Crane (R–IL)	do	10	([2])
H.R. 1770	Rep. David Dreier (R–CA)	do	14	([2])
H.R. 2520	Rep. Leon E. Panetta (D–CA)	do	18	18
H.R. 3516	Rep. Don Young (R–AR)	do	15	([2])
H.R. 4776	Rep. James H. Quillen (R–TN)	do	10	([2])
H.R. 4871	Rep. William Dannemeyer (R–CA)	do	[1]15	([2])
H.R. 5484	Rep. Ron Paul (R–TX)	do	10	([2])
S. 1767	Sen. George J. Mitchell (D–ME)	do	12–36	([2])
S. 2158	Sen. Mark Hatfield (R–OR)	do	6–30	([2])
S. 1040	Sen. Dan Quayle (R–IN)	do	15–30	30
H.R. 5711	Rep. Richard Shelby (D–AL)	Consumption tax	19	19
H.R. 5841	Rep. Cecil Heftel (D–HI)	Expenditure tax	10–50	30
S. 557	Sen. Dennis DeConcini (R–AZ)	do	19	19

[1] No greater than 15 percent.

Source: Margo Thorning, "Congressional Proposals for Fundamental Tax Reform: A Comparison", American Council For Capital Formation (Washington, D.C. July–August 1984).

Simple flat rate tax

Under this proposal, individuals are taxed on their income at a single flat rate. The single tax rate is applied to gross income after adjusting for personal exemptions.

The simple flat rate tax proposal provides no direct incentives for private savings and investment. It continues to discourage savings by taxing interest income. It seriously impairs the incentive to invest in productive, but nonetheless, risky enterprises. High income taxpayers would have their tax shelter already built into a flat rate system because their marginal rates would be sharply reduced. We would expect that taxpayers would be less likely to risk their capital for such reduced tax advantages. Buying Treasury bills would become more attractive and private investment would be hurt.

The flat rate tax proposal is not consistent with our traditional views of tax fairness embodied in the principle of progressivity. A pure flat rate income tax, for example, would increase the tax burdens of low- and middle-income households. Taxpayers with taxable income (1981 levels) below $50,000 would pay higher taxes while taxpayers above $50,000 would pay less taxes.

FIGURE 29.—DISTRIBUTION OF TAX LIABILITIES UNDER A 19.5 PERCENT FLAT RATE TAX[1] ON INCOME, LESS ZERO BRACKET AMOUNT, AT 1981 INCOME LEVELS

Expanded income (thousands)	Number of taxable returns (thousands)	Tax liability 1984 law (millions)	Tax liability flat tax (millions)	Percent change	Dollar change per return	Dollar[2] change in tax liability (millions)
0 to 5	6,482	403	1,574	290.7	+181	1,171
5 to 10	15,507	5,772	8,752	51.6	+198	2,980
10 to 15	13,092	12,526	17,610	40.6	+388	5,084
15 to 20	10,737	17,462	22,665	30.0	+485	5,203
20 to 30	16,800	44,080	52,871	19.9	+524	8,791
30 to 50	13,568	63,833	66,419	4.1	+191	2,586
50 to 100	3,580	38,687	30,846	−21.2	−2,291	−7,841
100 to 200	631	18,656	10,743	−42.4	−12,540	−7,913
Over 200	164	16,385	7,129	−56.5	−56,438	−9,256

[1] To facilitate comparison, 1984 law does not include the earned income credit, the two-earner couple deduction, or the IRA or Keogh provisions. The flat rate tax system similarly does not include those provisions.

[2] Calculated by subtracting flat rate tax liability (column 4) from 1984 law tax liability (column 3).

Source: United States Congress, Joint Committee on Taxation.

The flat rate income tax proposal does not encourage homeownership. It increases the tax burdens for low- and middle-income households which would decrease homeownership opportunities for a large number of taxpayers.

It repeals the deduction for home mortgage interest and property taxes, and the onetime $125,000 exclusion from taxation of capital gain from the sale of a principal residence by homeowners over the age of 55. Eliminating these homeownership tax incentives would sharply increase tax liabilities for low- middle-income homeowners. Many families could not qualify for a mortgage under existing rates without the tax incentives in the current law. Under a flat rate tax system, the homeownership rate would likely decline even further than what is now forecast.

FIGURE 30.—COMPARISON OF TAX LIABILITIES, SIMPLE FLAT RATE TAX AND CURRENT LAW, FAMILY OF FOUR, FILING JOINTLY

[Dollars, taxable year 1983]

	Homeowners		
	Low income ($20,000)	Middle income ($35,000)	High income ($70,000)
Flat rate tax liability [1]	$2,219	$5,069	$1,719
Minus: Crrent law liability	1,903	3,317	10,784
Equals: Change in tax liability [2]	1,126	1,752	935
Percentage change	103.0	52.8	8.7

[1] Simple flat rate tax system proposed by Senator DeConcini. Marginal tax rate is 19 percent.

[2] For low-income homeowner, tax liability based on a home price of $55,000, 80 percent financing with a 30-year mortgage at 13.50 percent. For middle-income homeowner, same financing assumptions based on a home price of $75,000. For high-income homeowner, same financing assumptions based on a home price of $150,000 (the average in California).

Source: National Association of Realtors®, Economics and Research Division.

The repal of homeownership tax incentives would also depress the value of residential property. The average home value is about $80,000 which yields annual tax savings of almost $2,600. Based on the typical characteristics of an owner-occupied single-family home, repeal of the homeownership tax incentives (deductability of mortgage interest and property taxes) would lower the after tax net income flow of an $80,000 home (including price appreciation) from about $1,500 per year to a *minus* $1,000 per year. This would clearly lower the value of residential property. We estimate the value of an $80,000 house would decline by about $12,000 or 16 percent.[2] This represents almost 25 percent of the amount of house equity for all households.[3]

FIGURE 31.—ANALYSIS OF THE RETURN ON INVESTMENT OF AN $80,000 HOME

	With current law homeownership tax savings	Repeal of current law homeownership tax savings
Home value	$80,000	$80,000
Minus downpayment [1]	$16,000	$16,000
Equals loan amount	$64,000	$64,000
Interest rate (percent) [2]	13.5	13.5
Term (years)	30	30
Imputed rental income from home [3]	$7,200	$7,200

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[2] The decline in value of a typical home is estimated as the discounted present value of the $2,558 of homeownership tax savings which would be lost if deductability of mortgage interest and property taxes is repealed. An eight year expected holding period and discount rate of 13.5 percent were assumed.

[3] The amount of equity in owner-occupied single-family detached homes for all households is about $50,500, based on survey results from the Joint Center for Urban Studies of MIT and Harvard University, Housing Futures Consumer Survey, October 1983.

FIGURE 31.—ANALYSIS OF THE RETURN ON INVESTMENT OF AN $80,000 HOME—Continued

	With current law homeownership tax savings	Repeal of current law homeownership tax savings
Minus mortgage interest	$8,630	$8,630
Minus operating expenses [4]	$2,000	$2,000
Minus property taxes [5]	$1,600	$1,600
Plus homeownership tax savings [6]	$2,558	0
Equals net income after taxes (excluding price appreciation)	−$2,472	−$5,030
Plus amount of appreciation [7]	$4,000	$4,000
Equals net income after taxes (including price appreciation)	$1,528	−$1,030

[1] Assumes a 20 percent downpayment.
[2] Blended rate of 30 year fixed rate mortgage and a 1 year adjustable rate mortgage.
[3] Assumed to be 9 percent of the home value.
[4] Assumed to be 2.5 percent of the home value.
[5] Assumed to be 2 percent of the home value.
[6] Assumes a marginal tax rate of 25 percent applied to deductions of mortgage interest and property taxes.
[7] Assumed to be 5 percent of the home value.

Source: National Association of Realtors.

Lowering residential property values by repealing the homeownership tax incentives, while significant for all homeowners, would be a major financial setback for the elderly or those about to retire, who have counted on a sale of the family home to produce retirement income. Almost 85 percent of the elderly are homeowners, and almost 80 percent of their total net assets are tied up in homeownership.

Homeownership tax savings reduce the need for growth in government mandated retirement programs such as Social Security. Repealing homeownership tax incentives would lower residential property values by 15 percent—$12,000 for the average house—and would reduce the total net assets of homeowners over 65 by 16 percent. Any decline in residential property values would clearly increase political and financial pressures on government retirement programs.

FIGURE 32.—NET ASSETS FOR HOMEOWNERS OVER 65 YEARS OLD

[1983 dollars]

Total net assets	$75,000
Home equity [1]	$59,000
Other assets	$16,000
Home equity as a percentage of total net assets [2]	78.7
Loss of home value as a percentage of home equity if homeownership tax savings were eliminated (as proposed in typical flat rate tax systems) [3]	20.3
Percentage decline in total net assets of elderly households if homeownership tax savings were eliminated	16.0

[1] Source: Joint Center for Urban Studies of MIT and Harvard University, "Housing Futures Consumer Preference Survey," October 1983.
[2] Source: F. Thomas Juster, "Current and Prospective Financial Status of the Elderly Population", in "Saving for Retirement," ed. by Phillip Cagan, Columbia University Graduate School of Business, 1981, pp. 35–56.
[3] Assumes average home value of $80,000.

Modified flat rate tax

The Bradley-Gephardt (B–G) and Kemp-Kasten (K–K) tax proposals are two examples of modified flat rate tax systems which try to overcome some of the problems of the simple flat rate tax.[4] Both plans continue to rely heavily on personal income taxes as a source of government revenue. The essential feature of the two plans is to broaden the income tax base by discontinuing most deductions, exclusions, allowances and credits and simplifying the tax rate structure. The B–G plan proposes three marginal tax rates of 14, 26, and 30 percent while the K–K plan uses a flat rate of 25 percent. Both plans retain deductability of IRA and KEOGH contributions. Kemp-Kasten retains a commitment to index the tax system so that inflation would not push taxpayers into higher brackets; Bradley-Gephardt repeals indexation.

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[4] "The Fair Tax Act of 1983" (H.R. 3271 and S.1472), introduced by Representative Gephardt and Senator Bradley. The "Fair and Simple Tax Act" (H.R. 5533 and S. 2600), introduced by Representative Kemp and Senator Kasten.

It is disappointing that both Bradley-Gephardt and Kemp-Kasten discontinue many existing tax incentives which encourage certain types of savings and investment. Both plans severely reduce the value of the deduction for home mortgage interest paid. Both plans continue the bias against personal savings by taxing them twice—once when the money is earned, and again when it produces income in an interest-earning investment. Both plans repeal the investment tax credit. Kemp-Kasten retains the current depreciation provisions while Bradley-Gephardt would end accelerated cost depreciation allowances, thus significantly lengthening the time over which rental and business real property would be depreciated. Both plans eliminate all tax credits for the preservation of historic and other buildings, and end tax exemptions for locally issued mortgage bonds. Repealing these provisions would have a severe adverse effect on investment in general, and real estate and homeownership in particular.

Bradley-Gephardt would limit the applicability of itemized deductions (including home mortgage interest) to the lowest bracket rate of 14 percent while totally disallowing these deductions for the bracket rates of 26 and 30 percent. Each dollar of deductions, therefore, would be worth only 14 cents in lower taxes in the B–G tax system compared to a maximum of 50 cents in the current system. Because of this change, homeownership tax savings in the B–G system would be 64 to 70 percent less than the savings in current law, or an average of $1,500 each year for each homeowner (see Figure 33). Because B–G lessens the value of the homeownership incentives, the value of residential property would likely decline by about 9 percent or $7,200 for the average homeowner.

Kemp-Kasten also limits the applicability of itemized deductions to a 25 percent marginal rate because it uses a single flat rate. However, the K–K plan also allows an "employment income credit" of 20 percent up to the FICA maximum wage base ($37,500 in 1984). For low- and middle-income taxpayers, it is an additional exemption which rises with income. Families with adjustable gross incomes below $14,374 would pay no taxes in the K–K system whereas tax begins at $8,640 in current law. The employment income credit is phased out for taxpayers earning more than the FICA maximum wage base (e.g., those earning more than $100,000 in 1984 would receive no credit). The impact of this provision compared to current law is to eliminate homeownership tax savings (and therefore the incentive to own) for families with adjustable gross income less than $14,373 (because they are removed from the tax roles up to this amount), increase homeownership tax incentives for families with adjustable gross incomes of $20,000 by about 45 percent (and the value of other itemized deductions retained), keep it about the same for middle-income taxpayers, and decrease it almost 40 percent for high-income taxpayers (see Figure 33). Overall, homeownership tax savings would be about $500 lower in the K–K tax system which would lower the value of residential properties by about 3 percent, or $2,400 for the average home.

FIGURE 33.—COMPARISON OF HOMEOWNERSHIP TAX SAVINGS, BRADLEY-GEPHARDT, KEMP-KASTEN AND CURRENT LAW, FAMILY OF 4, FILING JOINTLY

[Dollars, taxable year 1983]

	Low income ($20,000)	Middle income ($35,000)	High income ($70,000)
B–G tax savings	$266	$735	$2,310
Minus current law tax savings	758	2,055	7,826
Equals change in tax savings	−492	−1,320	−5,516
Percentage change	−64.9	−64.2	−70.5
K–K tax savings [1]	$1,100	$1,937	$4,750
Minus current law tax savings	758	2,055	7,826
Equals change in tax savings	342	−118	−3,076
Percentage change	45.1	−5.7	−39.3

[1] Taxpayers—family of four filing jointly—with adjustable gross incomes below $14,374 would pay no taxes in the Kemp-Kasten system whereas tax begins at $8,640 in present law. Thus, Kemp-Kasten completely eliminates the homeownership tax savings for families with adjustable gross incomes below $14,374.

For low-income homeowner, tax liability based on a home price of $55,000, 80 percent financing with a 30 year mortgage at 13.50 percent. For middle-income homeowner, same financing assumptions based on a home price of $75,000. For high-income homeowner, same financing assumptions based on a home price of $150,000.

Source: National Association of Realtors®, Economics and Research Division.

Consumed income tax

Simple and modified flat rate tax proposals do little to correct the bias against savings and investment in current law. An alternative model for tax reform is a tax on the amount of income consumed, rather than on the amount of income earned. A consumed income tax system, depending on how it is designed, could be a powerful way to increase savings.

There are four distinct ways to tax consumption: (1) an income tax with complete deductions for saving and investment; (2) a retail sales tax administered on a national basis; (3) a value-added tax charged on the amount that each stage in the production process adds to the final value of goods and services; and (4) a direct tax on people's consumption expenses, also known as an expenditure tax. The last alternative is very complicated and administratively difficult because few people keep such records or could reliably be forced to do so. Alternative (4) also poses serious transitional problems; such a system does not exist in any developed countries.

An income tax with deductions for savings and investment, however, is a feasible and effective way to increase savings. This version of the consumed income tax is not a radical departure from current law. Indeed, recent tax reform has been moving modestly in this direction. The introduction if Keogh, IRAs, 401(k) interest income exemptions, and lower tax rates on capital gains are other examples of taxing consumed income rather than earned income.

Tax reform should continue moving in this direction. Income invested in a savings account or other forms of investment, and interest or dividends earned, should not be taxed until it is withdrawn and spent.

An income tax with deductions for savings and investment would attract wide support and would have significant economic benefits. The stigma of regressivity leveled at consumption based taxes can be moved by making use of a progressive tax rate structure. A larger pool of savings would provide lower-interest mortgage money to help the young finance their homes which would improve both the economy and the nation's homeownership rate. Middle-aged and middle-income families would be able to save more for their children's education. More savings would help the unemployed by providing training, by creating new jobs, by increasing productivity and thereby increasing the competitiveness of U.S. products and services in world markets. More savings and investment and greater producticity would lower the price of goods and services for domestic use as well as making possible non-inflationary wage gains.

A version of the consumed income tax is a national sales tax administered at the retail level. A national retail sales tax has numerous advantages. It is relatively easy to administer. Compliance and the perception of compliance is improved. Saving and investment income are exempt automatically. It can be imposed quickly with little disruption to the present tax system. Public acceptance of the tax would assure a strong and politically stable base. And, it is a powerful revenue raiser (in 1984 it would raise about $25 billion dollars per percentage point).

The national sales tax, however, has many potential disadvantages. If a major consumer purchase such as a home were taxed at the retail level, it could cause an enormous redistribution of wealth away from homeowners, and it could increase the price of property beyond the financial means of many families. A national sales tax applied to the purchase of a home would clearly have a negative impact on the homeownership rate and thus on economic growth, and therefore should not be considered as part of any proposal for a national sales tax.

A national sales tax could increase inflation if it were included in official price indexes. Investment would be adversely effected because the value of the depreciation is reduced by inflation. Also, higher inflation would increase market interest rates.

A national sales tax could have other important disadvantages. it is a regressive tax in that it falls more heavily on lower-income households which, of necessity, spend a larger share of their income (although use of exemptions, differential rates, and a refundable income tax credit could offset the regressivity of a sales tax). It could erode an important tax base of state and local governments.

Because the national sales tax is a powerful revenue raiser, another potential major disadvantage is that it could facilitate undesirably higher levels of government spending.

Some, but not all, of the above cited disadvantages of a national sales tax could be overcome or avoided by the specific design of the tax.

Another version of the consumed income tax is the value-added tax (VAT) levied at each stage of the production process, not on gross sales or net income, but on the value added to the materials and supplies used in production at that stage. Many European countries use versions of the value added tax, and there are important lessons that can be learned from them.

All of the VAT systems in Europe treat investment exactly as they treat purchases of current inputs. This allows immediate deduction from sales income of the full value of investments made during the taxable period. Evidently the Europeans have concluded that a consumption type pro-investment VAT system is superior to any other type of system that may discourage investment.

All European nations exempt certain commodities from the value-added tax such as the services of owner-occupied housing, "social" goods such as health services and education, and banking and financial services which are difficult to value. Severe transitional problems arise if housing is subject to a VAT.

There are also regressivity and inflation problems associated with a valued-added tax for the same reasons these are problems with a national sales tax.

. A national sales tax, either at the retail level or at the production level, is fundamentally a device for increasing reliance on consumption taxation. As discussed above, there are advantages of less taxation on savings and investment and disadvantages of regressivity and competition with state and local governments. Some of the disadvantages are not easy to overcome.

Alternatively, it may be more efficient, feasible and less disruptive to increase existing provisions in the current income tax under which savings and investment are excused from taxation, such as the deferral of taxation on pensions funds, IRAs and KEOGH plans. In principle, the extension of such deferral arrangements and the creation of new ones would continue to convert the current tax system into a graduated tax on income less savings, and thus encourage greater investment, growth of jobs and a higher standard of living and quality of life for all Americans.

STATEMENT OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

(By Michael Foley, Director of Financial Management, and Jill L. Rowe, Director of Congressional Relations)

INTRODUCTION

This statement is submitted to the Committee on Ways and Means of the United States House of Representatives on behalf of the National Association of Regulatory Utility Commissioners (NARUC).

The NARUC is a quasi-governmental, nonprofit organization founded in 1889. Within our membership are the governmental agencies of the fifty states, the District of Columbia, Puerto Rico and the Virgin Islands which are engaged in the regulation of utilities and carriers. Our chief objective is to serve the consumer interest by seeking to improve the quality and effectiveness of government regulation in America.

The Association appreciates this opportunity to suggest some alternatives to restructuring the Internal Revenue Code in the area of energy taxes. More specifically, we would like to address the issues of the tax treatment of nuclear decommissioning costs; the ratemaking treatment of accelerated tax depreciation and investment tax credits (ITCs) for electric utilities; and the treatment of ITCs by natural gas pipelines.

Tax treatment of nuclear decommissioning costs

While the nuclear decommissioning tax issue was taken up this year in the House/Senate conference committee on the omnibus tax reform bill (H.R. 2163), we do not believe that the conference committee went far enough to resolve a problem which is creating an extra expense for citizens served by nuclear power plants. The conference adopted a plan which would essentially permit present value deductions to be taken over the life of a plant, but would not allow any additional deductions upon decommissioning. That plan is too narrowly drawn and will ultimately only affect few companies while the problem will remain with most of the industry.

The NARUC's study and recommendations on the nuclear decommissioning problem are intended to ease the financial crunch on citizens served by nuclear power far more than what the omnibus tax reform bill does. In trying to find an adequate solution to this tax problem, the Association on February 24, 1984 testified before the Subcommittee on Oversight of the Committee on Ways and Means on H.R. 2820, a bill which was designed to amend Section 162 of the Internal Revenue Code of 1954 so that amounts paid by customers to provide for future nuclear decommissioning costs would be recognized as a current expense for tax purposes.

The Internal Revenue Service (IRS) currently takes the position that the cost of decommissioning are not tax deductible expenses until they are actually incurred and monies are expended. The effect of that position is that monies are expended. The effect of that position is that monies that are collected from ratepayers during the life of the plant to pay for the expense that will come when the plant is no longer useful will be taxed as regular income.

Unless we are willing to ignore the real cost that is coming and hope that the ratepayers of that period will be able to pay for the cost of a nuclear plant which will provide them no benefit, we logically must recognize the reality of those future costs and allocate them to ratepayers who are receiving the benefits of lower cost electricity produced from those nuclear plants.

The policy of the IRS, however, is a disincentive to face those facts. The current IRS policy, which creates a mismatch between the taxes to be paid and the expenses which would offset those taxes, creates cost to current ratepayers in addition to the additional decommissioning requirements. Since utilities are required to pay the taxes, ratepayers are required to pay more so that tax dollars can be sent to the IRS until they are credited against taxes payable in the year or years after the decommissioning expense occurs.

When you calculate the costs of the alternatives, the simple fact is that with the compounding effect of the earning power of the dollars that ratepayers pay in through the years, a bill like H.R. 2820 would allow us to charge ratepayers fewer total dollars without increasing the total amount of the tax deduction earned for decommissioning expense.

Such legislation would provide a savings to ratepayers by simply matching the deductibility of nuclear decommissioning expenses with the actual payment of the expense by ratepayers. This would help ensure that funds for decommissioning expenses would be sufficient and would remove an unnecessary tax cost for ratepayers.

That funds are required to cover the costs of decommissioning is a certainty. We believe it is more equitable to collect those funds from ratepayers who benefit from nuclear power generation, rather than from future ratepayers. However, we believe that by taxing these receipts or by not allowing full deductions, the Federal government will discourage efforts to assure that the funds for decommissioning are available when the need for them arises.

The NARUC believes that legislation which contains the objectives of H.R. 2820 provides the least complicated and most effective way to resolve the inequity which exists under present law regarding the tax treatment of nuclear decommissioning costs.

The ratemaking treatment of accelerated tax depreciation and investment tax credits for electric utilities

The evolution of corporate tax law during the past 15 years has been marked by an alarming tendency by Congress to preempt the ratemaking functions which historically have been vested with the State regulatory commissions. The Economic Recovery Tax Act of 1981 is a prime example of Federal intrusion into legitimate State ratemaking authority in that it in effect requires the State commissions to implement normalization accounting treatment for those utilities which take advantage of accelerated depreciation and the investment tax credit.

Thus, the intent of current law is to prevent the States from having the flexibility to require the flow through of the tax benefits of the investment tax credits. In addition, the law prevents all utilities from using full economic normalization of the investment tax credit by specifying the options available to public utilities for recognizing tax credits when setting rates.

It is the view of the NARUC that this represents an excessive delegation of regulatory authority to the Department of the Treasury and essentially allows the Secretary of the Treasury to get involved in public utililty ratemaking—a function historically and properly reserved to the States.

On June 12, 1984 the NARUC testified before the Subcommittee on Energy Conservation and Power of the House Committee on Energy and Commerce on H.R. 4923, a bill proposing the Phantom Tax Reform and Least Cost Electric Energy Planning Act of 1984.

This bill would enable those State regulatory commissions which have developed a "least cost plan" for meeting the demands for electric energy service to determine the ratemaking treatment of accelerated tax depreciation and investment tax credits (ITCs) for electric utilities. States would thus have the discretion to choose between flow through and normalization ratemaking treatments of accelerated depreciation and investment tax credits now available to the electric utility industry. The bill would provide the Federal Energy Regulatory Commission (FERC) with similar discretion in setting wholesale electric rates, but would prohibit the Commission from approving a rate schedule which does not provide for economic normalization of the ITC or depreciation expenses and cost recovery deductions currently allowed under Federal law.

The problem as to the accounting treatment of investment tax credits has been particularly vexing to State regulators and ratepayers. The difficulties created by Federal mandate can best be understood by the use of a hypothetical example.

Assume that a utility company purchases an asset which costs $100,000 and that this asset has a life of 10 years. Because the asset qualifies for the ITC, the utility company will be entitled to deduct 10% of the cost of the asset, (in this case, $10,000), from the tax obligation which the company would otherwise owe to the Federal government. Thus, the real cost of the asset to the company has been reduced to $90,000 since the government has in effect provided a $10,000 capital subsidy at zero cost to the utility.[1]

The controversy arises over how the benefit of this $10,000 ITC should be accounted for in the utility ratemaking process. Current tax law provides that there should be a sharing of the ITC benefits between utility shareholders and ratepayers via an accounting technique known as "normalization".

However, the vast majority of utility companies have elected a normalization option, known as "cost-of-service normalization," which is considerably more beneficial to shareholders, to the detriment of ratepayers. Furthermore, this normalization option is inconsistent with the time-honored principles of the regulatory process.

Applying cost-of-service normalization to the hypothetical case described earlier would call for the utility company to deduct one-tenth of the $10,000 ITC benefit from the amount of revenues which the utility would otherwise be allowed to collect from ratepayers during each year of the life of the asset. Thus, allowed revenues would be reduced by $1,000 annually over the 10-year life of the asset. During the 10-year period, the portion of the ITC benefits which have not yet been returned to ratepayers is listed on the company's balance sheet as an "accumulated deferred ITC" (ADITC).

The inequity results from the current tax law which forces ratepayers to pay a rate-of-return on the ADITC's just as though the ITC benefits had been provided by the utility company's shareholders and bondholders. However, as the hypothetical example shows, none of the ITC benefits were provided by the utility's shareholders or bondholders but rather were provided as a Federal Government capital subsidy at zero cost to the recipient utility. The rate of return on ADITC's which utility consumers throughout the United States are being forced to shoulder is staggering and is actually increasing annually. In a report published by the Edison Electric Institute (EEI), ADITC's of the investor-owned electric utilities were reported to have increased by over 13 percent in 1983.[2] Needless to say, ADITC balances are also enormous and increasing rapidly in the gas and telephone industries.

The NARUC has consistently supported legislation to ameliorate the above-explained problem by permitting the States the option of using flow through or normalized methods of accounting.[3] The increasingly complex and even controversial nature of public utility regulation demands that decisions which directly impact the level of rates charged to consumers be made in the open forums of the State regulatory agencies.

Legislation such as H.R. 4923 would change the current law which prevents State utility commissioners from carrying out their sworn duty to protect utility ratepayers by giving them the discretion to return these tax benefits to consumers, although the bill would limit this option to only electric utilities with an approved least cost plan. (The NARUC would prefer to see legislation that would encourage States to consider least system cost plans without mandating them.) While all regulators are not in agreement as to which accounting procedure, flow through or normalization, is preferred, most agree that the States should have the right to determine the ratemaking practices for utility services under State jurisdiction.

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[1] It should be noted that current tax law is inconsistent in that it clearly recognizes accelerated depreciation tax benefits as zero cost capital but not ITC tax benefits.

[2] See EEI Statistical Yearbook/1982.

[3] See "NARUC Annual Convention Proceedings," pp. 1016–1019 (1979); "NARUC Annual Convention Proceedings," pp. 996–1000 (1980); "NARUC Annual Convention Proceedings," pp. 936–942 (1981); and "NARUC Annual Convention Proceedings," pp. 1227–1238 (1982).

Treatment of investment tax credits by natural gas pipelines

The regulatory treatment of investment tax credits by interstate natural gas pipelines has an immediate and direct impact upon the rates such pipelines may lawfully charge for natural gas supplies. As the national representative of the State agencies charged by law with the regulation of the distribution companies who are the primary customers of such pipelines, the NARUC is vitally concerned that FERC regulation of pipeline tax credits may result in unnecessarily high rates for natural gas service by distributors and their ultimate consumers.

The utilization of the investment tax credit by the nation's interstate natural gas pipeline companies has had a long and checkered history. Under the Revenue Act of 1962, natural gas pipeline companies were allowed a credit against Federal income tax of 7 percent of investment in qualified gas transmission properties. Since that time the availability of the credit has been suspended, repealed, reenacted, and expanded via subsequent revisions of the tax law.

Because the industry has generated over $2 billion in investment tax credits since 1962, the recognition of these credits is a matter of substance in the ratemaking process. As will be shown, the current FERC ratemaking treatment of the investment tax credit results in a clear ratepayer-to-stockholder subsidy which is violative of the time honored principles of the ratemaking process.

Unlike the regulatory treatment accorded investment tax credits generated by other public utilities, interstate natural gas pipeline companies have enjoyed a preference which results in substantial utility rate overcharges. The nature of this overcharge can be seen as follows. Under current FERC policy the Federal income tax component of a firm's cost of service is not adjusted to reflect the credit thus creating a *permanent* rate ovecharge. The firm is also permitted to collect from ratepayers, as an element of its cost of service, depreciation charges based upon the original cost of the asset without regard to the zero cost capital subsidy created by the investment tax credit. Similarly, consumers must pay a rate of return on an inflated rate base which has not been adjusted to reflect the capital subsidy.

Thus, assuming a $100,000 asset and a $10,000 ITC, ratepayers would pay a rate of return on the full original cost of the asset ($100,000) and the depreciable basis of the asset (also $100,000) would not be reduced to reflect the zero cost capital subsidy. Ratepayers would also pay rates based upon the firm's Federal taxes component of its cost of service which would not reflect the $10,000 ITC offset. Thus consumers would not share in the ITC benefit on either an immediate or deferred basis.

This clearly results in a substantial direct subsidy from ratepayers to stockholders which in turn causes natural gas rates to exceed those which would be in effect if conventional normalization ratemaking treatment were employed or if the natural gas pipeline industry simply did not qualify for the investment tax credit. Thus current FERC policy regarding the ITC has appropriately been termed "reverse flow through".

As was stated earlier, the adoption of reverse flow through by the FERC is a matter of substance because of the magnitude of the investment tax credits now being generated by the interstate natural gas pipeline companies. The availability of the investment tax credit and accelerated depreciation tax benefits has enabled the industry to substantially reduce its Federal income tax payments.

Thus at a time when natural gas rates and gas pipelines profits are increasing substantially, the industry is generating record investment tax credits which result in considerable rate overcharges due to current FERC ratemakiing policies. The magnitude and direction of this inequity begs for prompt resolution.

The immediate problem relevant to the preferential ratemaking treatment of the investment tax credit by natural gas pipeline companies has its origins in the Revenue Act of 1971. Congress allowed FERC's predecessor agency to provide the tax preference if it "determines that the natural domestic supply of the product furnished by the taxpayer in the course of such trade or business is insufficient to meet the present and future requirements of the domestic economy." [4]

On January 24, 1972 the Federal Power Commission issued Order No. 448, 47 F.P.C. 141 on the basis of "conclusive evidence demonstrating a gas supply shortage" and that "every indication is that such a shortage will continue into the near future."

Under Title 18 C.F.R. § 2.67a natural gas pipeline companies must implement reverse flow-through ratemaking treatment of the investment tax credit, "since the

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[4] Section 46(f)(1), I.R.C.; 26 U.S.C. § 46(f)(1).

Commission has determined that there is a natural domestic supply of gas insufficient at this time to meet the present and future requirements . . .". Though evidence may have existed 10 years ago to support this finding, it has become increasingly clear that such a finding can no longer be supported.

The NARUC supported H.R. 570, which would repeal the last sentence of paragraph (1) of Section 46(f) of the Internal Revenue Code and thereby provide that the normalization rules of the investment tax credit shall apply to natural gas pipelines without regard to the additional restriction imposed where there is a Federal determination that natural gas is in short supply.

Ultimately, the NARUC believes that I.R.C. 46(f)(1) should be restructured so that natural gas pipeline utilities may no longer employ reverse flow through ratemaking treatment of the investment tax credit.

CONCLUSION

The NARUC is very concerned with those sections of the Internal Revenue Code which place burdensome expenses on utility ratepayers or which hinder the States in the exercise fo their legitimate ratemaking authority. Therefore, we greatly appreciate this opportunity to make some suggestions to the Committee on how the Internal Revenue Code could be improved with respect to energy taxes.

National Candy Wholesalers Association, Inc.,
Washington, DC, September 19, 1984.

Hon. Dan Rostenkowski,
Chairman, House Committee on Ways and Means,
House of Representatives, Longworth House Office Building,
Washington, DC.

Dear Mr. Chairman: For consideration by your Committee and for inclusion in the Record of your hearings on September 25-27, 1984, we respectfully submit the following declarations of policy by our industry. These were unanimously adopted by our national convention in July of this year and we believe they speak for themselves:

Small Business Tax Relief—We favor continuing revision of the present Federal tax laws, as rapidly as feasible, to ease the especially heavy tax burden on small and medium size business enterprises, so that such enterprises may have a greater chance for survival, may retain more of their earnings for growth and modernization and may thus remain a strong factor in the field of competition. In addition to income tax relief for both incorporated and unincorporated enterprises, we favor further reductions in the rates of, and increases in exemptions from, estate and gift taxes and liberal payment terms for those taxes so as to relieve a burden causing forced sales by heirs of small business owners.

Federal Sales Tax—We oppose a Federal sales tax, especially as applied to food, but in any event because in the long run it would not reduce other taxes; we would end up with all the taxes we have now, and a Federal sales tax, too.

"Value Added" Tax—We oppose new forms of taxation such as the "value added" tax which would ultimately provide no relief frm excessive and unfair burdens of present taxation but instead only add to total taxation, encourage waste and needless government spending, regressively burden and discourage consumption of commodities, fall most heavily on consumers least able to pay, increase the burdens on and further discourage private enterprise, and in the case of the "value added" tax, discriminate against the candy wholesaling and other industries which by their nature add great value to the materials or products they process or distribute.

Death Tax on Small Businesses—We oppose taxation of unrealized appreciation of capital assets at time of death, which would force small businessmen or their heirs to sell or liquidate their businesses and further accelerate the trend toward business concentration and destruction of competition and opportunity.

Respectfully,

Russell L. Shipley, Jr.,
Executive Vice President.

STATEMENT OF RAYMOND C. SCHEPPACH, EXECUTIVE DIRECTOR, NATIONAL GOVERNORS' ASSOCIATION

SUMMARY

My statement summarizes the state perspective on the importance of federal tax reform, illustrates the profound and varied effect that federal tax decisions have on state governments, and provides an update on actions taken by the Governors to prepare for the coming debate on tax reform. Two critical points I wish to make to the Committee are:

First, federal tax policy decisions do affect state revenue collections and must be made with full knowledge of their effect on states.

Second, states are partners with the federal government in the funding and administration of many critical programs, so Governors must be full participants in decisions that affect the states' capacity to meet their obligations.

State and local governments get most of their revenues from taxes they impose, not from the federal government. The interconnection between the federal tax code and state tax provisions is very close, and the varied nature of state tax laws means that a revision in the federal law will affect states in widely differing ways.

In my testimony, I describe some aspects of state general sales, income, and corporation net income taxes—the three largest sources of state revenue—and show how federal tax decisions affect states in each case. For example, I illustrate the relevance of the variety of state sales tax rates to federal policy makers by showing that the average federal tax savings from the deductibility provision per itemizing taxpayer is approximately $60, but the per capita effect is $105 in New York, $85 in Washington, and $2 in Oregon.

The NGA Chairman, Governor John Carlin, has established a Task Force on Tax Reform. The Task Force will be chaired by Governor Richard Lamm, and Governor Carlin, Governor Thornburgh, Governor Alexander, and Governor Matheson will serve as members. The work of the Task Force is still in the very early stages, but it appears that it will be focusing on four major reform alternatives: a flat tax, a modified flat tax, (such as the Bradley-Gephardt or the Kemp-Kasten proposals), a "cash flow" (or personal expenditure) tax, and a value added/retail sales tax.

While the Task Force has not yet reported its recommendations, our work on the tax issue to date suggests that states will apply the following criteria to any federal tax reform initiative:

It must create incentives for real economic growth, providing long-term benefits to our people and offering an adequate revenue base to support the programs of federal, state, and local governments.

It must ensure that the burden of any changes fall equitably on all affected by the tax system.

It must recognize the close connection of the federal and state tax systems. Some tax code provisions—affecting tax-exempt bond financing and deductibility of state and local taxes, for example, are clearly of an intergovernmental nature. But federal decisions on matters which do not appear related to state governments—such as the Accelerated Cost Recovery System and Individual Retirement Accounts—also have an important impact on states. This interweaving of state and federal tax codes means that careful study of the full effect of a proposed change is essential prior to its enactment and that adequate lead time must be provided to enable states to adjust their systems as necessary.

It must recognize that a marked expansion of federal reliance on excise or sales taxes will have a widely varying impact from state to state and could hamper the states' ability to raise additional revenues at a time when many important responsibilities are being assumed by state governments.

It must incorporate the results of extensive consultation with state officials.

STATEMENT

Mr. Chairman and Members of the Ways and Means Committee, at the outset of my testimony, I wish to thank you, Mr. Chairman, and the members of the Ways and Means Committee for the leadership you have shown in debating and acting on some of the most complicated and important issues facing our nation today.

In my statement, I will summarize the state perspective on the importance of tax reform, illustrate the profound and varied effect that federal tax decisions have on state governments, and update you on actions taken by the Governors to prepare for the coming debate on tax reform. Two critical points I wish to make to you are:

First, federal tax policy decisions do affect state revenue collections and must be made with full knowledge of their impact on states.

Second, states are partners with the federal govenment in the funding and administration of many critical progrmas, so Governors must be full participants in decisions that affect the states' capacity to meet their obligations.

IMPETUS FOR TAX REFORM

State and local governments get most of their revenues from taxs they impose, not from the federal government. As the experience of 1981 and 1982 proved again, weakness in the national economy translates into severe fiscal stress for state governments, cutbacks in their programs, increases in state taxes to maintain existing programs, and a general inability to make necessary program expansions or start new priority initiatives.

The national economy has made a strong comeback. While states are recovering from the recession, the results of our latest survey indicate that the states' balances are still well below the levels reached in fiscal years 1979 and 1980. In those years, aggregate ending balances exceeded $1 billion, and, as a percent of expenditures, the balances exceeded 9 percent. Overall, we estimate that states will end their 1984 fiscal years with an aggregate balance around $5 billion, which is equal to approximately 3 percent of expenditures and is still below the 5 percent considered a prudent balance by most Wall Street analysts.

In any case, the overriding interest of Governors in federal tax policy is the same as the Ways and Means Committee's: that the tax code be part of a national economic policy that promotes U.S. competitiveness and gains in real output. We urge the Committee to study carefully the effect of tax reform options on the economy and to continue its efforts to ensure that the tax code does not constitute an obstacle to economic growth.

Beyond this broad concern, Governors are aware that American taxpayers and academic experts alike believe that the federal tax system is seriously deficient with respect to the three goals of any tax system—simplicity, fairness, and efficiency. A 1983 poll conducted by the Advisory Commission on Intergovernmental Relations (ACIR) asked the public to identify "the worst tax." The federal income tax attracted a 35 percent response, substantially higher than the second worst tax, the property tax, with 26 percent. In response to the same question in 1972, only 19 precent chose the federal income tax as the worst tax.

From the state perspective, there is growing concern that the decreasing confidence in the federal tax system will be transferred to states. Specifically, concern on the part of taxpayers that the federal income tax is unfair or is to high can create an unwillingness to comply fully with other taxes perceived as being part of the same system (e.g., a state income tax.) State and local officials therefore have a stake in the simplification and improvement of the federal tax code, because disillusionment with federal taxes may affect state revenue collections.

STATE TAX PROFILE

Although Governors support federal efforts to simplify the federal tax system, NGA does not underestimate the difficulty of the task. Moreover, Governors are well aware that such changes could have a major impact on state government. The interconnection between the federal tax code and state tax provisions is very close, and the varied nature of state tax laws means that a revision in the federal law will affect states in widely differing ways. It is for these reasons that federal tax policies involve more than a federal revenue decision; they often have an important impact on the intergovernmental system as well.

Let me give you a few examples that illustrate how state general sales, income, and corporation net income taxes—the three largest sources of state revenue—are affected by federal tax decisions. Forty-five states levy a general sales tax (as distinct from selected sales taxes); the rates range from a low of 3 percent (in 7 states) to a high of 7.5 percent (in one state, Connecticut). As a group, states raise over 30 percent of their tax revenue through the general sales tax, but the importance of the tax varies widely when viewed on a state-by-state basis, as table 1 shows. The state of Washington relies most heavily on the general sales tax, generating 58.6 percent of its tax revenue using this method, while in the five states without a sales tax—Alaska, Delaware, Montana, New Hampshire and Oregon—the percentage generated is obviously zero.

Why is the variation in state sales tax rates relevant to federal tax policy? For one thing, it explains why many states view continuation of federal tax provisions permitting deductibility of sales taxes as an important priority. The average federal tax savings from the deductibility provisions per itemizing taxpayer is approximately $60, but the per capita effect is $105 in New York, $85 in Washington, and $2 in

Oregon (see table 2). This variation makes reaching consensus on the sales tax deductibility issue more difficult and suggests that if federal changes were made, major revisions in state tax laws would likely follow.

The base of the sales tax also varies greatly among the states, as table 3 shows. For example, 42 states exempt prescription medicine, 41 states exempt barber and beauty services, 24 exempt auto repair services, and so on down the list. This fact is important because it suggests that administration of any national sales tax would be more difficult than many suppose. Businesses not now subject to a state sales tax presumably would be covered by a national tax. The resulting paperwork and confusion for both the private sector and the Internal Revenue Service could be considerable.

Turning to the individual income tax, we see the same pattern. Forty-three states currently levy an income tax, but the tax in Connecticut, New Hampshire, and Tennessee affects only interest and dividends, not wages and salaries. Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming have no income tax at all. About 30 percent of state revenues nationwide are generated by the income tax, but in Oregon (which does not have a general sales tax) over 66 percent of the state revenue is raised through a tax on personal income. Of course, the seven states without an income tax get none of their revenue this way (see table 1).

The definition of income used by the states also varies greatly; 29 states use the federal definition of income as the basis for state tax liability, 11 states use their own definitions of income, and four states use federal tax liability (see table 4). It is easy to see that the Individual Retirement Account provisions included in the Economic Recovery Act of 1981 (ERTA) would have a dramatic effect on states that "piggy-back" on federal income definitions; state officials had to deal not only with the revenue consequences of unpredictable economic conditions in 1981, but unpredictable federal tax policy as well.

The same pattern also holds for state corporate taxes. About 8 percent of state revenues across the country come from a corporate income tax, but tax rates and reliance on the corporate tax vary widely. Indiana has adopted a rate of 3 percent, while Iowa and Minnesota apply a rate of 12 percent. Five states (Nevada, South Dakota, Texas, Washington and Wyoming) have no state corporate income tax, while New Hampshire raises 22 percent of its revenue through a corporate tax.

Before 1981, most states used federal definitions of corporate income for their own tax systems, so when ERTA established a new and more rapid form of depreciation known as the Accelerated Cost Recovery System (ACRS), state tax revenues were affected directly. After ERTA's enactment, states had to decide whether and how to follow the new federal depreciation provisions. In many cases, state legislation that was enacted in 1981 or 1982 on an emergency basis had to be revised in 1983 after states had an opportunity to access the impact of the federal change. Thirteen states have decided not to allow part of ACRS and five states (California, Georgia, New Jersey, New York and Oregon) do not use the federal definition of ACRS at all. Most states had sought to rely on federal definitions as a convenience to corporations, but this objective has been compromised because the resulting revenue loss was too great for many states. Moreover, the very short lead time afforded states to examine the potential effect of the federal change required action without full analysis, leading to further changes in state tax codes and further inconvenience for corporations.

I have concentrated on the fifty states in the state tax profile I have provided here, but I must note that the U.S. flag territories have developed similar reliance on the federal tax code. The very name of the practice used in several of the territories—the mirror system—should alert policymakers to the impact that federal tax code changes have on the revenue systems of the territories.

To summarize then, the federal tax code is woven into the fabric of state tax systems in a myriad of ways. Federal decisions must take this fact into account by determining before enactment what the effect of a proposal on states would be and by consulting with state officials, and permitting adequate lead time for states to adjust if there is to be a tax code revision affecting them.

NGA TASK FORCE ON TAX REFORM

In view of the growing congressional interest in tax reform and of the President's directive that he receive an options paper on the issue by the end of the year, Kansas Governor John Carlin, Chairman of the Association, has established a Task Force on Tax Reform. The Task Force will be chaired by Colorado Governor Richard Lamm, and Governors Carlin, Thornburgh of Pennsylvania, Alexander of Tennessee, and Matheson of Utah will serve as members. The charge to the group is to analyze the range of tax reform options now being proposed and to complete the background work necessary to enable the Governors to be active in the coming debate. It is our current plan to discuss tax reform in some detail at our winter meeting in February, and, if necessary, adopt a comprehensive policy at that time.

The work of the task force is still in the very early stages, but it appears that we will be focusing on four major reform alternatives: a flat tax, a modified flat tax, (such as the Bradley-Gephardt or the Kemp-Kasten proposals), a "cash flow" (or personal expenditure) tax, and a value added/retail sales tax.

We are looking at the flat tax and the modified flat tax as possible responses to widespread public concern that the tax code is unfair, due in part to the $270 billion in deductions and credits that have been incorporated in it over the years. Broadening the income tax base has the potential to improve the efficiency, simplicity and fairness of the federal tax system. Such a reform also has the potential of reducing marginal tax rates, which should increase incentives to work, save, and invest.

From a state and local government perspective, however, proposals to broaden the tax base immediately raise a number of issues. The changes could affect the deductibility of state and local income, property, and general sales taxes, which will weaken public support for state taxes. Furthermore, changing federal tax provisions relating to the deductibility of one particular state tax (e.g., sales tax) present a major problem because the value of the deduction differs substantially among the states, as I pointed out earlier.

The priority states have placed on maintaining the tax-exempt status of municipal bonds has been conveyed to you in numerous forums over the years. More than one-third of all state and local capital expenditures are financed through provisions in the tax code affecting general obligation and revenue bonds, and preservation of these provisions is of the highest priority, given the importance of infrastructure to the economy. Therefore, this issue also will be a subject of study by the Task Force.

The cash flow and value added/retail sales taxes are on the agenda because we recognize that from a long-run economic standpoint, these taxes have the advantage of using actual consumption as the base. Such an approach should reduce consumer spending and increase savings, leaving more money available for investment and leading to higher productivity and growth in the long run. All other things being equal, these taxes should have the effect of reducing interest rates nad increasing investment. On the negative side, however, sales and value added taxes can be regressive. Furthermore, if they are imposed without a concurrent deduction in the federal income tax, the tax system would maintain many of the efficiency and fairness problems which the reform effort is to address.

From the state and local perspective, these consumption-oriented taxes pose a problem because they intrude into the tax area traditionally relied upon by state and local government. In addition to the general sales tax, which I mentioned earlier, states impose selected sales taxes. Taken together, total sales and gross receipts taxes account for 49 percent of state tax collections.

Conventional wisdom holds that taxpayers will resist taxation above a certain threshold. The difference between current taxation and the threshold is the "tax room," and any federal use of the tax base eats up what is left for state and local government use. Also, federal consumption taxes might tend to reduce national spending as consumers shift their consumption patterns in response to price increases due to the imposition of a sales or a value added tax. Any reduction in sales would also reduce state and local tax revenues to the extent that they depend on consumption. For these reasons, Governors would be very concerned about the imposition of major new federal consumption taxes.

CONCLUSION

In summary, our work on the tax issue to date suggests that states will apply the following criteria to any federal tax reform initiative:

It must create incentives for real economic growth, providing long-term benefits to our people and offering an adequate revenue base to support the programs of federal, state, and local governments.

It must ensure that the burden of any changes fall equitably on all affected by the tax system.

It must recognize the close connection of the federal and state tax systems. Some tax code provisions—affecting tax-exempt bond financing and deductibility of state and local taxes, for example, are clearly of an intergovernmental nature. But federal decisions on matters which do not appear related to state governments—such as the Accelerated Cost Recovery System and Individual Retirement Accounts—also have an important impact on states. This interweaving of state and federa tax codes means that careful study of the full effect of a proposed change is essential prior to its enactment and that adequate lead time must be provided to enable states to adjust their systems as necessary.

It must recognize that a marked expansion of federal reliance on excise or sales taxes will have a widely varying impact from state to state and could hamper some states' ability to raise additional revenues at a time when many important responsibilities are being assumed by state governments.

It must incorporate the results of extensive consultation with state officials.

In any reform of the federal tax system, states must be viewed as partners in the advancement of public policy improvements, not as just another interest group. Our concerns, which by necessity must be expressed in terms of specific comments and proposals, reflect truly generalized apprehension about the overall health of the economy and the condition of the federal budget.

The states and the federal government have a commonality of interest in maintaining a growing and productive economy, which is the source of both our tax bases. In addition, we have a shared responsibility in the funding and administration of many critical government services, ranging from health and welfare programs to transportation and evironmental programs. These shared responsibilities argue for specific evaluation of the impact of each proposal on state and local governments. The National Governors' Association stands ready to assist you in this regard.

TABLE 1.—STATE GOVERNMENT TAX COLLECTIONS IN 1983: PERCENT DISTRIBUTION OF STATE GOVERNMENT TAX REVENUE FOR SELECTED TAXES

	General sales	Individual income	Corporation net income
State:			
Alabama	28.2	23.8	5.7
Alaska	(X)	.1	13.0
Arizona	41.0	23.3	7.8
Arkansas	32.7	29.0	6.5
California	34.9	34.4	11.5
Colorado	35.7	37.6	3.2
Connecticut[1]	43.5	7.0	14.1
Delaware	(X)	49.1	4.7
Florida	53.6	(X)	6.0
Georgia	33.5	38.3	6.8
Hawaii	52.2	30.2	1.9
Idaho	26.7	36.1	5.0
Illinois	32.3	29.7	8.1
Indiana	47.6	25.6	4.4
Iowa	28.4	35.9	6.9
Kansas	31.8	33.9	9.0
Kentucky	26.9	24.9	6.6
Louisiana	27.8	7.6	10.7
Maine	34.7	30.2	4.2
Maryland	24.9	42.1	4.3
Massachusetts	20.4	48.0	12.8
Michigan	28.0	36.6	14.3
Minnesota	23.0	45.8	5.9
Mississippi	49.5	13.1	4.5
Missouri	37.3	33.5	4.5
Montana	(X)	29.5	7.0
Nebraska	36.1	28.4	5.2
Nevada	47.3	(X)	(X)
New Hampshire[1]	(X)	5.1	22.4
New Jersey	27.1	23.5	10.8
New Mexico	41.0	1.4	5.3
New York	21.8	51.1	8.3
North Carolina	20.5	38.5	7.6
North Dakota	27.8	6.7	5.8
Ohio	29.8	29.3	6.2
Oklahoma	15.6	24.8	3.9
Oregon	(X)	66.3	7.0

TABLE 1.—STATE GOVERNMENT TAX COLLECTIONS IN 1983: PERCENT DISTRIBUTION OF STATE GOVERNMENT TAX REVENUE FOR SELECTED TAXES—Continued

	General sales	Individual income	Corporation net income
Pennsylvania	28.1	24.3	9.8
Rhode Island	29.2	35.9	5.8
South Carolina	32.7	34.0	6.1
South Dakota	53.5	(X)	.8
Tennessee [1]	52.4	2.3	9.1
Texas	36.8	(X)	(X)
Utah	40.2	35.5	3.2
Vermont	18.6	31.8	7.1
Virginia	20.7	44.5	5.3
Washington	58.6	(X)	(X)
West Virginia	50.7	21.1	3.1
Wisconsin	28.1	40.4	7.9
Wyoming	25.8	(X)	(X)

[1] Income tax is not a tax on wages and salaries; it affects only interest and dividends.

Source: State Government Tax Collections in 1983, U.S. Department of Commerce, Bureau of the Census.

TABLE 2.—FEDERAL TAX SAVINGS FROM DEDUCTIBILITY PROVISION, PER TAXPAYER,[1] BY STATE, 1980

	Deductibility of all State and local taxes	Deductibility of sales taxes only
Alabama	$273.64	$74.41
Alaska	326.92	42.24
Arizona	322.68	75.65
Arkansas	312.36	45.45
California	591.37	89.45
Colorado	400.23	69.35
Connecticut	528.39	96.70
Delaware	614.45	7.68
Washington, DC	916.74	75.47
Florida	226.91	58.76
Georgia	392.94	60.20
Hawaii	564.14	83.88
Idaho	345.96	40.59
Illinois	432.31	88.44
Indiana	271.83	58.89
Iowa	413.47	43.03
Kansas	378.73	54.00
Kentucky	371.21	57.94
Louisiana	192.01	82.36
Maine	439.04	56.22
Maryland	640.19	67.89
Massachusetts	656.90	47.62
Michigan	553.47	59.02
Minnesota	584.38	45.21
Mississippi	277.23	76.56
Missouri	342.54	66.21
Montana	315.96	3.26
Nebraska	445.44	60.42
Nevada	192.89	49.02
New Hampshire	348.78	7.49
New Jersey	569.05	66.05
New Mexico	295.62	73.80
New York	892.12	105.01
North Carolina	417.11	50.93
North Dakota	251.24	37.71
Ohio	346.53	51.70

TABLE 2.—FEDERAL TAX SAVINGS FROM DEDUCTIBILITY PROVISION, PER TAXPAYER,[1] BY STATE, 1980—Continued

	Deductibility of all State and local taxes	Deductibility of sales taxes only
Oklahoma	335.65	57.37
Oregon	461.75	2.16
Pennsylvania	445.33	58.74
Rhode Island	547.65	60.89
South Carolina	341.30	54.48
South Dakota	230.15	72.00
Tennessee	203.03	89.16
Texas	232.78	75.57
Utah	329.37	62.41
Vermont	521.44	33.16
Virginia	477.91	58.60
Washington	234.82	85.68
West Virginia	344.22	50.32
Wisconsin	573.05	49.95
Wyoming	161.71	73.46
U.S. Average [2]	410.21	59.07

[1] Number of taxpayers was calculated by adding number of single returns itemizing state-local taxes to twice the number of joint returns itemizing state-local taxes. In 1980, 31% of all returns itemized state-local taxes. 96% of the returns itemizing some state-local tax itemized sales tax deductions. (Internal Revenue Service, "Statistics of Income—1980, Individual Income Tax Returns," Washington, D.C.: U.S. Government Printing Office, 1982, Publication 79 (9–82), pp. 36, 56.)

[2] U.S. total excludes Puerto Rico and citizens abroad.

Source: ACIR staff computations using unpublished 1980 IRS Individual Income Tax Model file.

TABLE 3.—*Major Sales Tax Exemptions, 1984*

	Number of States exempting
Consumer goods:	
Groceries	28
Prescription medicine	42
Motor fuels	37
Alcoholic beverages	4
Cigarettes	12
Services:	
Residential gas and electricity	27
Residential water	38
Telephone and telegraph	18
Laundry and dry cleaning	28
Barber and beauty services	41
Amusements	21
Management consulting	43
Computer and data processing	26
Legal services	43
Maintenance services	37
Auto repair services	24
Agricultural goods:	
Feeds, seed, fertilizer, etc.	43
Agricultural machinery	24
Business goods:	
Sales for resale	44
Production machinery	30
Materials used in processing	44

Source: State of Texas Revenue Department.

TABLE 4.—DEFINITIONS OF INCOME USED BY THE STATES AS THE STATE INDIVIDUAL INCOME TAX BASE

States that use Federal definition of income for State tax base, 29 States and DC:

Arizona, Colorado, Delaware, District of Columbia, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa.
Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana.
New Mexico, New York, North Dakota,[1] Ohio, Oklahoma, Oregon, Utah, Virginia, West Virginia, Wisconsin.
States that use their own definition of income for State tax base, 11 States:
Alabama, Arkansas, California, Connecticut, Mississippi, New Hampshire, New Jersey, North Carolina, Pennsylvania, South Carolina, Tennessee.
States that use Federal tax liability for State tax base, four States:
Nebraska, North Dakota,[1] Rhode Island, Vermont.
States with no Income Tax, seven States:
Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming,

[1] Taxpayer has option of choosing method of calculation.

Source: "Comparison of Selected Tax Rates in the District of Columbia With Those of the Fifty States" D.C. Government June 1983.

ONE TAX ALLIANCE,
Arlington, VA, September 22, 1984.

Hon. DAN ROSTENKOWSKI,
House of Representatives.

MY DEAR SIR: We have testified since 1980 that a bottom up reverse revenue sharing tax levied on individual earned income is the preferred method of raising revenue. With no exemptions, deductions or credits, sufficient revenue for all needs would be raised as well as eliminating tax returns and the immense infrastructures accumulated over the years. The details would consist of simple agreements between localities, states and the government attainable under the present Constitution and its amendments now in force.

A sampling survey of wage and salary earners, the majority source of taxes, has indicated an overwhelming preference for this type of tax as their fair share to support of the governments which are their representatives to prevent force and fraud.

We trust that the implication in Press Release #29 that statements for the record does not exclude consideration of recommendations made therein. It is to be noted that those invited to testify are pretty much other than representative of the tax paying public.

We stand ready to testify on a tax system understandable to the majority.

Sincerely,

SAMUEL GREENBERG, *Chairman.*

STATEMENT OF BERNARD M. (BOB) SHAPIRO, NATIONAL DIRECTOR FOR TAX POLICY, AND LARRY L. DILDINE, DIRECTOR OF TAX ECONOMICS, PRICE WATERHOUSE

INTRODUCTION

We appreciate the opportunity to present the views of Price Waterhouse on tax reform and simplification to the Committee on Ways and Means. This testimony was prepared by Bernard M. (Bob) Shapiro, who is the National Director for Tax Policy and a former chief of staff of the Joint Committee on Taxation, and Larry Dildine, who is the Director for Tax Economics and is a former deputy director for the Treasury Department Office of Tax Analysis.

Attached to our statement is an outline of the various considerations facing Congress as it explores simplification and reform of the present tax system. We chose the format of a summary statement and an outline to present an easy-to-follow listing of the reasons for the makeup of the current tax Code and our recommendations for action by the congressional tax-writing committees. We also have included a number of exhibits illustrating some of the complexity that faces taxpayers today. We look forward to presenting this testimony when the Committee on Ways and Means holds additional hearings on reform/simplification and restructuring.

THE CURRENT TAX SYSTEM

Tax policy must be tested against the objectives of equity, simplicity, and economic efficiency, at the same time keeping in mind the primary purpose of the tax system—to distribute among taxpayers the costs and burdens of funding the Government and servicing the Federal debt.

Tax policy cannot, however, meet all of the three objectives in each situation. A fair tax would not be simple, and a simple tax would not be fair.

As a result, our tax Code has evolved into a system which has narrowed the tax base by providing deductions, exemptions, and exclusions to encourage specific activities or provide equity in the system. The result is that tax rates are correspondingly higher than they would be were more income included in the base.

Recently, tax policy has been increasingly subject to economic and political pressures. The budget and reconciliation processes have required the tax-writing committees to raise additional revenues to moderate deficits and, in general, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the Deficit Reduction Act of 1984 have used expansion of the tax base to increase revenues. These bills have been legislated under short deadlines and Congress has been forced to deal with tax Code reform and simplification in piecemeal, rather than comprehensive, fashion.

There are three principal types of taxes under the current tax Code:

The income tax, which places progressive tax rates on defined sources of income.

The payroll tax, which places a flat tax rate on income from wages and salaries.

Various excise taxes and user fees, which tax consumption or use of certain items or services.

The progessive income tax system was designed to require that those with higher incomes pay a higher percentage of their income in taxes. Congress has enacted various credits, deductions, exclusions, and exemptions which were added to the Code to encourage certain social or economic objectives or, in some cases, to balance the relative tax burdens among different classes of individual taxpayers and different types of business taxpayers. Congress also has enacted various prohibitions and penalties to discourage abusive or excessive sheltering of income and to enforce compliance.

There is a widespread perception that the current income tax system is unnecessarily complex or unfair. There are a number of reasons for this:

Offsetting tax incentives have led to a complicated tax system designed to further social or economic goals or to create balance among businesses and individuals but which foster the perception that the tax Code favors certain classes of taxpayers over others.

Deductions, exclusions, and exemptions erode the tax base and thus require higher rates, which lead to additional efforts to shelter income.

Definitions and the eligibility for certain incentives are ambiguous to many taxpayers, and thus create uncertainty and are subject to abuse.

Recent reform efforts have added increased complexity to the tax Code. In addition, the public focus on perceived abuses in the tax Code have furthered the impression that the Code favors certain classes of taxpayers over others.

One alternative which many taxpayers feel would make the system more fair is a "flat" tax approach. Much of the complication in the current tax Code would remain, however, even if a "flat" tax proposal were enacted; Congress still would be faced with deciding whether to review Subchapters C through U of Chapter 1 of Subtitle A of the Tax Code, as well as the remaining Subtitles, and would still leave substantial volume and complexity in the Code. In addition, a pure flat tax would remove a number of the provisions designed to provide fairness that Congress has built into the Code. For example, Congress could raise additional revenue simply by increasing the "flat" tax already in operation in our system—the payroll tax—but we doubt that many taxpayers would regard such an action as a fair approach to raising additional revenue or to simplifying the system.

This is not intended to indicate that an attempt to simplify the income tax should not be made. We applaud the efforts of those who have introduced various tax reform/simplification bills as a necessary first step in the congressional dialogue necessary to draft structural reform legislation.

Our purpose is to make clear that the majority of these proposals, and particularly the "flat" tax proposals, would retain a number of the exemptions, credits, deductions, and exclusions now in the tax Code. Even if reasonable simplification efforts are successful, a substantial amount of complexity will continue; complex transactions, particularly business transactions, require complex rules and, in general, business has established internal and external mechanisms to deal with complex tax Code provisions. Additionally, there is a general perception that if Congress explores the "flat" tax proposals it would be extremely difficult to broaden the base to the extent proposed in those bills because of equity consideration, incentives for certain activities, and the strong political support for so many of the credits, deductions, exclusions, and exemption in current law.

RECOMMENDATION

Our principal recommendation (see pages 8 through 13 of the attached outline) is a method which has been used successfully (although to a limited extent) in the past in areas such as Subchapter S and installment sales, and which we feel would provide a significant advantage if removed from the pressures of raising additional revenue.

We recommend that the congressional tax-writing committees and their staffs lead a systematic review of the income tax. We do not endorse a separate commission to make recommendations, but suggest that the congressional tax-writing committees determine their proper review process and seek the assistance of the Administration, tax practitioners, academia, and business and community leaders. The objective would be to produce a balanced, revenue-neutral legislative package which would garner the widest possible support.

The review would be undertaken in stages, the first concentrating on those individuals—wage and salary earners with dividend and interest income but little or no investment income—who make up the majority of the tax-paying population. This review would concentrate on Subchapters A and B of the income tax and would focus on simplification and fairness questions. As part of this effort, Congress might consider limiting certain deductions and credits that may be ambiguous or subject to abuse. Ultimately, the goal would be to reduce tax rates while maintaining the same relative tax burdens by income class.

Congress then could turn its attention to individuals with investment income, and examine the items in the current tax Code which allow some persons to shelter income from taxation. The objectives of this review would be fairness and economic efficiency—ensuring that proper incentives for saving and innovation are supplied and the use of scarce capital is most effective. Congress also should review the treatment of capital gains, taking into account that while the separate treatment of capital gains is an important incentive for innovation and saving, it also is a major source of complexity in the tax Code and must be balanced against the goal of lowering all tax rates.

The third stage would be a review of the deductions, credits, exclusions, and exemptions available to the business community. In particular, this review could examine ways to reduce the intrusion of taxes on business decisions and avoid directing scarce capital to less productive uses. Congress also should study whether there are greatly different tax burdens among competing businesses under the current system, and whether a much broader base would provide more equity to business than current tax incentives which often cancel each other out.

This third stage would be followed by a similar review of special provisions in the Code for financial institutions and for international transactions.

The result might be a package which would offer the business community the following trade-of: reductions in corporate and the top individual tax rates in return for including a larger amount of business income in the tax base.

With those stages completed, the tax-writing committees could turn to the task of meeting revenue targets by adjusting rates or adopting new supplementary taxes. We realize that budget objectives may very well require the tax-writing committees to raise additional revenues, at least in the short term. The committee must consider whether a fairer, simpler income tax is the best vehicle for raising additional revenue.

Our recommendation is broad and would require a substantial commitment of time and resources. It also would be essential that it be undertaken without the two most prevalent pressures—a short lead time and the need for additional revenues—which have characterized TEFRA and the 1984 tax bill. In the event that additional revenues are needed to lower deficits, the review should be undertaken first and then rates could be adjusted temporarily to achieve revenue targets or a supplementary revenue source such as a value-added tax could be added to the system if Congress determines that such action is proper and necessary.

Outline of Testimony Presented by Bernard M. Shapiro and Larry L. Dildine, on Behalf of Price Waterhouse

I. WHAT ARE TAX POLICY GOALS?

A. Tax policy must be tested against the objectives of equity, simplicity, and economic efficiency, but cannot meet all three criteria in each situation.

1. A fair tax would not be simple.
2. A simple tax would not be fair.

B. Congressional tax-writers cannot ignore the three objectives, but must make certain trade-offs to further other social or economic goals.

C. Emphasis on the three criteria depend on which type of taxpayer is under consideration:

1. For individuals, the most important considerations are equity and simplicity; efficiency is less of an issue in the taxation of wage-earners.

2. For businesses, the most important criteria are equity and a tax policy that promotes economic efficency; simplicity is not as important a criteria because of the specific activities of most businesses and the necessary record-keeping which has required the appropriate internal and external mechanisms to deal with the complexity of the tax Code in their particular situations.

II. THE PRESENT TAX SYSTEM

A. The purpose of the tax system is to distribute the costs and burdens of funding the Government and servicing the Federal debt:

1. The tax system is designed to provide the necessary revenues.

a. The broader the tax base, the lower the rates necessary to provide the revenue needed to fund the Government.

b. Narrowing of the tax base through exemptions, exclusions, deductions, and credits has been done to encourage activities (social, economic, political, energy, trade, etc.) endorsed by Congress.

c. Most past efforts to provide equity in the system have concentrated on dealing with the base of the income tax by reviewing exemptions, exclusions, and deductions for particular types of activities or classes of taxpayers, and have resulted in a system with an income tax base that is much less than total income with correspondingly higher rates.

2. Current tax policy incrasingly is the result of economic and political pressures:

a. The budget/reconciliation process each year since 1981 has required the tax-writing committees to raise additional revenues to moderate deficits. In contrast to past experience, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the Deficit Reduction Act of 1984 primarily used expansion of the tax base to increase revenues.

b. These reform efforts have been legislated in short time periods, and have been forced to deal in piecemeal, rather than comprehensive, fashion with the tax Code.

B. Components of the current tax system:

1. The two main components of the tax system are the tax base and the tax rates:

a. Rates—one rate on all income would provide simplicity, while graduated rates with certain credits provide equity.

b. Base—a broad base provides simplicity, while certain exclusions, exemptions, and deductions provide equity.

2. The current tax system provides three principal types of taxes:

a. The income tax (progressive rates on most sources of income).

b. The payroll tax (flat rate on income from wages and salaries).

c. Excise taxes (consumption taxes with various rates on certain items).

C. There is a widespread perception that the current income tax system is unfair and unnecessarily complex:

1. The progressive income tax system was designed to require that those with higher incomes pay a higher percentage of their income in taxes.

2. Deductions, credits, exclusions, and exemptions were added to encourage certain social and economic objectives rather than to raise taxes and, in some cases, to balance the relative tax burdens among different classes of individual taxpayers and different types of business taxpayers.

3. Prohibitions and penalties on specific activities were designed to discourage abusive or excessive sheltering of income and to enforce compliance.

4. Reasons for the perception of inequity and added complexity:

a. Offsetting tax incentives have led to a complicated tax system designed to create balance among businesses and individuals but which fosters the perception that the tax system favors certain classes of taxpayers over others.

b. Tax incentives erode the tax base and thus require higher tax rates, which lead to additional efforts to shelter income.

c. The definitions of some deductions and credits are ambiguous to many taxpayers and thus create uncertainty and are subject to abuse.

d. Rules do not apply uniformly based on the legal "fiction" of entities.

e. Recent reform efforts have added to increased complexity of the tax code.

D. The "flat" tax versus the progressive income tax under the current system:

1. The payroll tax is a form of the "flat" tax.

2. Comparison of the current income tax system to the payroll tax system.

a. The income tax applies to income from all sources but has a number of exceptions, while the payroll tax has few adjustments but is applied only against wages and salaries.

b. The income tax is complex, while the payroll tax is simple.

c. While it would be possible to increase revenue by simply increasing the payroll tax and earmarking additional revenue to a separate account or the general fund to lower deficits, such an approach may not be desirable for tax and social policy reasons because it is regressive and would tend to increase the perception of unfairness.

E. Current proposals for simplification:

1. Most of the "flat" tax proposals do not provide a single tax rate and would continue some of the credits, deductions, exclusions, and exemptions under current law.

2. There is a general perception that if Congress explores the "flat" tax proposals it would be extremely difficult to broaden the base to the extent proposed in those bills because of equity considerations, incentives for certain activities, and the strong political support for certain credits, deductions, exclusions, and exemptions.

F. Taxable entities require specific review and analysis:

1. Individuals:

a. Wage-earning individuals.

b. Individuals with investment income:

i. Investment for profits.

ii. Investment for sheltering of income.

c. Individuals with business income.

d. Items for individuals—deductions, credits, exclusions, and exemptions:

i. Itemized vs. nonitemized deductions.

ii. Items which foster social or economic goals, e.g., the charitable deduction, the mortgage interest deduction, the medical expense deduction.

ii. Politically motivated, e.g., the deduction for state and local taxes which makes it easier for state and local governments to raise revenue.

2. Business entities:

a. Sole proprietorships.

b. Partnerships.

c. Subchapter S corporations.

d. Corporations:

i. Domestic non-financial corporations.

ii. Multinational non-financial corporations.

iii. Financial entities (banks, thrift institutions, insurance companies, regulated investment companies, and real estate investment trusts).

e. Items for businesses:

i. Deductions for ordinary and necessary business expenses.

ii. Items which foster social, economic, etc. goals—the deduction for pension and profit-sharing plans, intangible drilling costs, the research and experimentation credit, etc.

3. Miscellaneous entities:

a. Tax-exempt organizations.

b. Cooperatives.

c. Trusts and estates.

d. Others.

G. Tax Code considerations:

1. Most current reform and simplification proposals deal only with Subchapters A and B of Chapter 1 of Subtitle A of the tax Code (Attachment A).

2. Congress still will be faced with deciding whether to review Subchapters C through U of Chapter 1 of Subtitle A, as well as the remaining Subtitles, which will still leave substantial volume and complexity in the Code.

3. Provisions that are detailed and may appear complicated could instead provide simplicity by being so specific that taxpayers clearly know what is or is not allowed.

4. Forms (Attachments B and D):

a. 1040EZ.

b. 1040A.

c. 1040.

d. Special schedules, worksheets, etc.

H. Statistics (reflects figures for 1983 tax returns filed through April 1984):

1. Percentage of filers who use Form 1040EZ—17.1.

2. Percentage of filers who use Form 1040A—21.1.

3. Percentage of filers who use Form 1040—61.8.

a. Those who itemize—57.4 percent of those who file Form 1040 (35.5 percent of all taxpayers).

b. Those who would not itemize except for home ownership—26.2 percent of itemizers.

4. Attachment (C) showing:

a. The percentage of all individual taxpayers who used each line of the Form 1040 in 1981.

b. The percentage of Form 1040 filers who used each form and schedule in 1981.

I. Desirability of an additional tax mechanism:

1. Simplification/reform efforts in general concentrate on revenue neutrality.

2. Deficit pressures are likely to require Congress to raise additional revenues in 1985 and thereafter.

3. Revenue-neutral tax reform may require that Congress find additional revenue from an alternative source, such as a value-added tax or a national sales tax:

a. A new tax would add complexity (a new Subtitle) to an already complex tax code.

b. A value-added tax or a national sales tax would add a substantial administrative burden.

4. The tax-writing committees and Congress must determine whether the additional complexity and burdens on business and individuals would be worth the revenue from a new tax.

III. RECOMMENDATIONS

A. Undertake a systematic review of the income tax without revenue considerations or a deadline:

1. Method of conducting the review:

a. The review would be led by the tax-writing committees and their staffs.

b. The committees could solicit advice and support from the Administration, tax practitioners, academia, and business and community leaders.

2. Purpose of the review:

a. To develop a balanced legislative package (not just a study).

b. To build support among the public and business.

3. Initial goals of a legislative package:

a. Approximately revenue-neutral.

b. Same relative burdens by income class (i.e., continued progressivity of the rate structure) and between individuals and businesses.

c. Simpler for individuals.

d. Fairer for all groups.

e. Less intrusion in business decisions.

4. Develop legislation in a number of stages:

a. The first stage focuses on a broad group of taxpayers.

b. There are somewhat different objectives for each group.

c. Work primarily on the tax base first, and then adjust the rates.

B. Review of the form and structure of the Tax Code:

1. Undertake a systematic review of the forms to illustrate the complexities and concepts of the Tax Code.

2. Undertake a systematic review of the structure of the Tax Code, particularly as it relates to the concepts of:

a. Gross income.

b. Above-the-line deductions.

c. Adjusted gross income.

d. Itemized deductions.

e. Taxable income.

f. Tax credits.

C. First stage—Wage and salary earning households:

1. This would include those individuals whose income is made up almost entirely of wages, salaries, and dividend and interest income.

2. This is the largest segment of the population:

3. Revise portions of Subchapters A and B—a relatively small part of the Code.

4. Focus on simplified filing and fairness questions:

a. Some complications may be necessary for fairness:

i. The two-earner deduction for married couples.

ii. Income averaging for fluctuating incomes and the special 10-year averaging provisions.

iii. Deductions for extraordinary medical expenses and casualty losses.

b. Some aspects of fairness add complexity:

i. Adding fringe benefits and other nonwage compensation to the tax base.

ii. Allowing individuals to compute the sales deduction based on receipts rather than using the sales tax tables.

5. Look for changes that are both simple and fair:

a. The elimination of certain deductions and credits would allow lower rates.

b. Areas to consider:

i. Above-the-line deductions.

ii. Itemized deductions.

iii. Credits.

6. Consider limiting certain deductions that may be ambiguous or subject to abuse:

a. This is the source of much of the perception of unfairness in the Tax Code.

b. Drawing "bright line" tests could give the perception of greater fairness and end ambiguity among taxpayers.

c. Examples are charitable contributions of property and certain employee business expenses.

D. Second stage—Households with substantial investment income:

1. These would be individuals who in addition to wages, salaries, and dividend and interest income also have substantial additional investment income.

2. This group is more likely to use the deductions, credits, exclusions, and exemptions for sheltering of their income through the following three elements of tax shelters:

a. Leverage (use of borrowed money).

b. Deferral (accelerated deductions).

c. Conversion (ordinary income to capital gains).

3. Objectives for this review:

a. Economic efficiency issues:

i. Incentives for saving and innovation.

ii. Use of scarce capital.

iii. Unproductive tax shelters.

b. Equity issues:

i. Differential treatment of equally productive assets.

ii. Relative tax burden in investment income as compared to wages is perceived as unfair to wage earners.

iii. Sheltering of wage and salary income.

c. Complexity is largely unavoidable:

i. Income is not always in cash.

ii. Transactions are often complicated.

4. Examine the sheltering of income:

a. Compare economic effectiveness with equity objectives.

b. Consider the treatment of interest on both sides of the transaction.

5. Review the treatment of capital gains:

a. The separate treatment of capital gains is a major source of complexity in the tax Code.

b. It is an important incentive for innovation and risk-taking.

c. The fairness question must take into account the effects of inflation.

d. The separate treatment of capital gains must be balanced against the goal of lowering all tax rates.

6. Review the purpose and consequences of state and local tax-exempt obligations.

E. Third state—Nonfinancial businesses:

1. This basically is the treatment of all business income, but would not concentrate on Code Subchapters which provide special treatment for certain types of financial businesses (see below).

2. This review would examine the use by business of deductions, exclusions, exemptions, and credits.

3. Objectives of this review:

a. Economic efficiency:

i. Reduce intrusion of taxes on business decisions.

ii. Avoid directing scarce capital to less productive uses.

iii. Provide incentives where market incentives are insufficient.

iv. Incentive provisions for certain industries or types of investment may cancel each other out.

b. Fairness issues:

i. There may be greatly different tax burdens among competing businesses under the current system.

ii. There may be some unintended preferences under the current system.

iii. Unreported income in the "underground economy".

4. Possible solutions:

a. Offer the business community a trade—reductions in corporate tax rates and top individual tax rates in return for including a larger amount of business income in the tax base and a re-examinaiton of the business credit structure.

b. Reform Subchapter C to neutralize tax considerations in reorganizations.

c. Explore ways to improve compliance for the portion of the self-employment income in the "underground economy."

d. Investigate further the expansion of eligibility for Subchapter S, in lieu of integration or the use of a shareholder credit.

F. Fourth stage—Financial institutions and international transactions:

1. This would include a review of the special rules for financial institutions (including banks, thrift institutions, insurance companies, and regulated investment companies and real estate investment trusts), and for international transactions.

2. Examine the changing roles of these institutions in financial markets and the extent that they provide an intermediary function.

3. The same criteria applied in E. above would be applied to those institutions.

G. Fifth stage—Rates, personal exemptions, and alternative revenue sources:

1. Consider adjusting the personal exemptions:

a. To adjust for inflation since the last increase.

b. To reduce the number of taxpayers.

c. To increase the tax-exempt level of income.

2. Adjust individual tax rates:

a. To achieve unchanged distribution by income class.

b. To achieve revenue neutrality.

c. To preserve prior agreements on trade-offs.

d. To simplify the rate structure, if possible.

3. Consider changing the revenue target:

a. Further rate reductions may be desirable to leave more taxpayers "whole."

b. Greater revenue may be needed if spending reductions and economic growth are insufficient to close the budget deficit.

4. Compare the income tax to alternatives as a supplementary revenue source:

a. The principal alternative is a value-added tax (VAT).

b. VAT would add an entirely new Code subtitle.

c. VAT is a tax on consumption, and probably would require many exceptions for fairness.

d. Would VAT provide a fairer tax base than a reformed income tax base?

e. There are important political considerations: can the income tax be reformed without promised rate reductions?

5. Adjust the income tax rates or add a VAT to achieve the revenue target.

H. Sixth stage—Additional simplification/reform stages:

1. Tax-exempt and tax-favored organizations—Subchapters F, T, and U.

2. Estates and trusts—Subchapter J.

IV. REVIEW OF QUESTIONS POSED IN THE COMMITTEE ON FINANCE PRESS RELEASE

A. Distributional impact of base broadening/rate reduction:

1. The distributional impact by income class need not be altered significantly when the rates are adjusted appropriately.

2. Relief for families and low-income individuals could be provided by an increased exemption.

3. A VAT to make up any revenue shortfall would reduce the progressivity of the overall system.

B. Degree of progressivity:

1. This should not just be a by-product of base broadening.

2. This is a strictly political determination.

3. The overall degree of progressivity need not be affected.

C. Transition problems:

1. Most can be solved by "grandfathering," or a phase-in of new provisions.

2. Congress could avoid applying large changes to existing assets.

3. A VAT usually ignores transition, it could have major impacts by type of business, and it is not easy to "grandfather."

D. Simplification for individuals and corporations:

1. It is more feasible for individuals without major investment or business income.

2. Investment and business income requires complex record-keeping, but tax planning can be reduced.

E. Taxation without regard to form of business organization:

1. Consider expanding the availability of Subchapter S.

2. This is an objective in Subchapter C reform.

ATTACHMENT A

INTERNAL REVENUE TITLE

Subtitle A.	Income taxes.
Subtitle B.	Estate and gift taxes.
Subtitle C.	Employment taxes.
Subtitle D.	Miscellaneous excise taxes.
Subtitle E.	Alcohol, tobacco, and certain other excise taxes.
Subtitle F.	Procedure and administration.
Subtitle G.	The Joint Committee on Taxation.
Subtitle H.	Financing of presidential election campaigns.
Subtitle I.	Trust Fund Code.

Subtitle A—Income Taxes

Chapter 1.	Normal taxes and surtaxes.
Chapter 2.	Tax on self-employment income.
Chapter 3.	Withholding of tax on nonresident aliens and foreign corporations.
Chapter 4.	Rules applicable to recovery of excessive profits on government contracts.
Chapter 5.	Tax on transfers to avoid income tax.
Chapter 6.	Consolidated returns.

CHAPTER 1—NORMAL TAXES AND SURTAXES

Subchapter A.	Determination of tax liability.
Subchapter B.	Computation of taxable income.
Subchapter C.	Corporate distributions and adjustments.
Subchapter D.	Deferred compensation, etc.
Subchapter E.	Accounting periods and methods of accounting.
Subchapter F.	Exempt organizations.
Subchapter G.	Corporations used to avoid income tax on shareholders.
Subchapter H.	Banking institutions.
Subchapter I.	Natural resources.
Subchapter J.	Estates, trusts, beneficiaries, and decedents.
Subchapter K.	Partners and partnerships.
Subchapter L.	Insurance companies.
Subchapter M.	Regulated investment companies and real estate investment trusts.
Subchapter N.	Tax based on income from sources within or without the United States.
Subchapter O.	Gain or loss on disposition of property.
Subchapter P.	Capital gains and losses.
Subchapter Q.	Readjustment of tax between years and special limitations.
Subchapter S.	Tax treatment of S corporations and their shareholders.
Subchapter T.	Cooperatives and their patrons.
Subchapter U.	General stock ownership corporations.
Subchapter V.	Title II cases.

Subchapter A—Determination of Tax Liability

Part I. Tax on individuals.
Part II. Tax on corporations.
Part III. Changes in rates during a taxable year.
Part IV. Credits against tax.
Part VI. Minimum tax for tax preferences.

PART I—TAX ON INDIVIDUALS

Sec. 1. Tax imposed.
Sec. 2. Definitions and special rules.
Sec. 3. Tax tables for individuals having taxable income of less than $20,000.
Sec. 5. Cross references relating to tax on individuals.

PART II—TAX ON CORPORATIONS

Sec. 11. Tax imposed.
Sec. 12. Cross references relating to tax on corporations.

PART III—CHANGES IN RATES DURING A TAXABLE YEAR

Sec. 15. Effect of changes.

PART IV—CREDITS AGAINST TAX

Subpart A. Nonrefundable personal credits.
Subpart B. Foreign tax credit, etc.
Subpart C. Refundable credits.
Subpart D. Business-related credits.
Subpart E. Rules for computing credit for investment in certain depreciable property.
Subpart F. Rules for computing targeted jobs credit.

Subpart A—Nonrefundable Personal Credits

Sec. 21. Expenses for household and dependent care services necessary for gainful employment.
Sec. 22. Credit for the elderly and the permanently and totally disabled.
Sec. 23. Residential energy credit.
Sec. 24. Contributions to candidates for public office.
Sec. 25. Interest on certain home mortgages.
Sec. 26. Limitation based on tax liability; definition of tax liability.

Subpart B—Foreign Tax Credit, Etc.

Sec. 27. Taxes of foreign countries and possessions of the United States; possession tax credit.
Sec. 28. Clinical testing expenses for certain drugs for rare diseases or conditions.
Sec. 29. Credit for producing fuel from a nonconventional source.
Sec. 30. Credit for increasing research activities.

Subpart C—Refundable Credits

Sec. 31. Tax withheld on wages.
Sec. 32. Earned income.
Sec. 33. Tax withheld at source on nonresident aliens and foreign corporations.
Sec. 34. Certain uses of gasoline and special fuels.
Sec. 35. Overpayments of tax.

Subpart D—Business Related Credits

Sec. 38. General business credit.
Sec. 39. Carryback and carryforward of unused credits.
Sec. 40. Alcohol used as fuel.
Sec. 41. Employee stock ownership credit.

Subpart E—Rules for Computing Credit for Investment in Certain Depreciable Property

Sec. 46. Amount of credit.
Sec. 47. Certain dispositions, etc., of section 38 property.
Sec. 48. Definitions; special rules.
Sec. 49. Termination for period beginning April 19, 1969, and ending during 1971.
Sec. 50. Restoration of credit.

Subpart F—Rules for Computing Credit for Employment of Certain New Employees

Sec. 51. Amount of credit.
Sec. 52. Special rules.

PART VI—MINIMUM TAX FOR TAX PREFERENCES

Sec. 55. Alternative minimum tax for taxpayers other than corporations.
Sec. 56. Corporate minimum tax.
Sec. 57. Items of tax preference.
Sec. 58. Rules for application of this part.

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Subchapter B—Computation of Taxable Income

Part I.	Definition of gross income, adjusted gross income, taxable income, etc.
Part II.	Items specifically included in gross income.
Part III.	Items specifically excluded from gross income.
Part IV.	Determination of marital status.
Part V.	Deductions for personal exemptions.
Part VI.	Itemized deductions for individuals and corporations.
Part VII.	Additional itemized deductions for individuals.
Part VIII.	Special deductions for corporations.
Part IX.	Items not deductible.
Part X.	Terminal railroad corporations and their shareholders.
Part XI.	Special rules relating to corporate preference items.

PART I—DEFINITION OF GROSS INCOME, ADJUSTED GROSS INCOME, TAXABLE INCOME, ETC.

Sec. 61.	Gross income defined.
Sec. 62.	Adjusted gross income defined.
Sec. 63.	Taxable income defined.
Sec. 64.	Ordinary income defined.
Sec. 65.	Ordinary loss defined.
Sec. 66.	Treatment of community income.

PART II—ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

Sec. 71.	Alimony and separate maintenance payments.
Sec. 72.	Annuities; certain proceeds of endowment and life insurance contracts.
Sec. 73.	Services of child.
Sec. 74.	Prizes and awards.
Sec. 75.	Dealers in tax-exempt securities.
Sec. 77.	Commodity credit loans.
Sec. 78.	Dividends received from certain foreign corporations by domestic corporations choosing foreign tax credit.
Sec. 79.	Group-term life insurance purchased for employees.
Sec. 80.	Restoration of value of certain securities.
Sec. 81.	Certain increases in suspense accounts.
Sec. 82.	Reimbursement for expenses of moving.
Sec. 83.	Property transferred in connection with performance of services.
Sec. 84.	Transfer of appreciated property to political organization.
Sec. 85.	Unemployment compensation.
Sec. 86.	Social security and tier 1 railroad retirement benefits.
Sec. 87.	Alcohol fuel credit.

PART III—ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

Sec. 101. Certain death benefits.
Sec. 102. Gifts and inheritances.
Sec. 103. Interest on certain governmental obligations.
Sec. 104. Compensation for injuries or sickness.
Sec. 105. Amounts received under accident and health plans.
Sec. 106. Contributions by employer to accident and health plans.
Sec. 107. Rental value of parsonages.
Sec. 108. Income from discharge of indebtedness.
Sec. 109. Improvements by lessee on lessor's property.
Sec. 110. Income taxes paid by lessee corporation.
Sec. 111. Recovery of tax benefit items.
Sec. 112. Certain combat pay of members of the Armed Forces.
Sec. 113. Mustering-out payments for members of the Armed Forces.
Sec. 114. Sports programs conducted for the American National Red Cross.
Sec. 115. Income of States, municipalities, etc.
Sec. 116. Partial exclusion of dividends and interest received by individuals.
Sec. 117. Scholarships and fellowship grants.
Sec. 118. Contributions to the capital of a corporation.
Sec. 119. Meals or lodging furnished for the convenience of the employer.
Sec. 120. Amounts received under qualified group legal services plans.
Sec. 121. One-time exclusion of gain from sale of principal residence by individual who has attained age 55.
Sec. 122. Certain reduced uniformed services retirement pay.
Sec. 123. Amounts received under insurance contracts for certain living expenses.
Sec. 124. Qualified transportation provided by employer.
Sec. 125. Cafeteria plans.
Sec. 126. Certain cost-sharing payments.
Sec. 127. Educational assistance programs.
Sec. 128. Interest on certain savings certificates.
Sec. 129. Dependent care assistance programs.
Sec. 130. Cross references to other Acts.
Sec. 130. Certain personal injury liability assignments.
Sec. 131. Certain foster care payments.
Sec. 132. Certain fringe benefits.
Sec. 133. Interest on certain loans used to acquire employer securities.
Sec. 134. Cross references to other Act.

PART IV—DETERMINATION OF MARITAL STATUS

Sec. 143. Determination of marital status.

PART V—DEDUCTIONS FOR PERSONAL EXEMPTIONS

Sec. 151. Allowance of deductions for personal exemptions.
Sec. 152. Dependent defined.
Sec. 153. Cross references.

PART VI—ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

Sec. 161. Allowance of deductions.
Sec. 162. Trade or business expenses.
Sec. 163. Interest.
Sec. 164. Taxes.
Sec. 165. Losses.
Sec. 166. Bad debts.
Sec. 167. Depreciation.
Sec. 168. Accelerated cost recovery system.
Sec. 169. Amortization of pollution control facilities.
Sec. 170. Charitable, etc., contributions and gifts.
Sec. 171. Amortizable bond premium.
Sec. 172. Net operating loss deduction.
Sec. 173. Circulation expenditures.
Sec. 174. Research and experimental expenditures.
Sec. 175. Soil and water conservation expenditures.
Sec. 176. Payments with respect to employees of certain foreign corporations.
Sec. 177. Trademark and trade name expenditures.
Sec. 178. Depreciation or amortization of improvements made by lessee on lessor's property.
Sec. 180. Expenditures by farmers for fertilizer, etc.
Sec. 182. Expenditures by farmers for clearing land.
Sec. 183. Activities not engaged in for profit.
Sec. 184. Amortization of certain railroad rolling stock.
Sec. 185. Amortization of railroad grading and tunnel bores.
Sec. 186. Recoveries of damages for antitrust violations, etc.
Sec. 188. Amortization of certain expenditures for child care facilities.
Sec. 189. Amortization of real property construction period interest and taxes.
Sec. 190. Expenditures to remove architectural and transportation barriers to the handicapped and elderly.
Sec. 191. Amortization of certain rehabilitation expenditures for certified historic structures.
Sec. 192. Contributions to black lung benefit trust.
Sec. 193. Tertiary injectants.
Sec. 194. Amortization of reforestation expenditures.
Sec. 194A. Contributions to employer liability trusts.
Sec. 195. Start-up expenditures.
Sec. 196. Deduction for certain unused business credits.

PART VII—ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS

Sec. 211. Allowance of deductions.
Sec. 212. Expenses for production of income.
Sec. 213. Medical, dental, etc., expenses.
Sec. 215. Alimony, etc., payments.
Sec. 216. Deduction of taxes, interest, and business depreciation by cooperative housing corporation tenant-stockholder.
Sec. 217. Moving expenses.
Sec. 219. Retirement savings.
Sec. 221. Deduction for two-earner married couples.
Sec. 222. Adoption expenses.
Sec. 223. Cross references.

PART VIII—SPECIAL DEDUCTIONS FOR CORPORATIONS

Sec. 241. Allowance of special deductions.
Sec. 243. Dividends received by corporations.
Sec. 244. Dividends received on certain preferred stock.
Sec. 245. Dividends received from certain foreign corporations.
Sec. 246. Rules applying to deductions for dividends received.
Sec. 246A. Dividends received deduction reduced where portfolio stock is debt financed.
Sec. 247. Dividends paid on certain preferred stock of public utilities.
Sec. 248. Organizational expenditures.
Sec. 249. Limitation on deduction of bond premium on repurchase.
Sec. 250. Certain payments to the National Railroad Passenger Corporation.

PART IX—ITEMS NOT DEDUCTIBLE

Sec. 261. General rule for disallowance of deductions.
Sec. 262. Personal, living, and family expenses.
Sec. 263. Capital expenditures.
Sec. 264. Certain amounts paid in connection with insurance contracts.
Sec. 265. Expenses and interest relating to tax-exempt income.
Sec. 266. Carrying charges.
Sec. 267. Losses, expenses, and interest with respect to transactions between related taxpayers.
Sec. 268. Sale of land with unharvested crop.
Sec. 269. Acquisitions made to evade or avoid income tax.
Sec. 269A. Personal service corporations formed or availed of to avoid or evade income tax.
Sec. 269B. Stapled entities.
Sec. 271. Debts owed by political parties, etc.
Sec. 272. Disposal of coal or domestic iron ore.
Sec. 273. Holders of life or terminable interest.
Sec. 274. Disallowance of certain entertainment, etc., expenses.
Sec. 275. Certain taxes.
Sec. 276. Certain indirect contributions to political parties.
Sec. 277. Deductions incurred by certain membership organizations in transactions with members.
Sec. 278. Capital expenditures incurred in planting and developing citrus and almond groves; certain capital expenditures of farming syndicates.
Sec. 279. Interest on indebtedness incurred by corporation to acquire stock or assets of another corporation.
Sec. 280. Certain expenditures incurred in production of films, books, records, or similar property.
Sec. 280A. Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.
Sec. 280B. Demolition of structures.
Sec. 280C. Certain expenses for which credits are allowable.
Sec. 280D. Portion of Chapter 45 taxes for which credit or refund is allowable under Section 6429.
Sec. 280E. Expenditures in connection with the illegal sale of drugs.
Sec. 280F. Limitation on investment tax credit and depreciation for luxury automobiles; limitation where certain property used for personal purposes.
Sec. 280G. Golden parachute payments.

Subchapter O—Gain or Loss on Disposition of Property

Part I. Determination of amount of and recognition of gain or loss.
Part II. Basis rules of general application.
Part III. Common nontaxable exchanges.
Part IV. Special rules.
Part V. Changes to effectuate F. C. C. policy.
Part VI. Exchanges in obedience to S. E. C. orders.
Part VII. Wash sales of stock or securities.
Part VIII. Distributions pursuant to Bank Holding Company Act of 1956.

PART I—DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

Sec. 1001. Determination of amount of and recognition of gain or loss.
Sec. 1002. Recognition of gain or loss [repealed].

PART II—BASIS RULES OF GENERAL APPLICATION

Sec. 1011. Adjusted basis for determining gain or loss.
Sec. 1012. Basis of property—cost.
Sec. 1013. Basis of property included in inventory.
Sec. 1014. Basis of property acquired from a decedent.
Sec. 1015. Basis of property acquired by gifts and transfers in trust.
Sec. 1016. Adjustments to basis.
Sec. 1017. Discharge of indebtedness.
Sec. 1018. Adjustment of capital structure before September 22, 1938. [repealed]
Sec. 1019. Property on which lessee has made improvements.
Sec. 1021. Sale of annuities.
Sec. 1023. Carryover basis for certain property acquired from a decedent dying after December 31, 1976
Sec. 1024. Cross references.

PART III—COMMON NONTAXABLE EXCHANGES

Sec. 1031. Exchange of property held for productive use or investment.
Sec. 1032. Exchange of stock for property.
Sec. 1033. Involuntary conversions.
Sec. 1034. Rollover of gain on sale of principal residence.
Sec. 1035. Certain exchanges of insurance policies.
Sec. 1036. Stock for stock of same corporation.
Sec. 1037. Certain exchanges of United States obligations.
Sec. 1038. Certain reacquisitions of real property.
Sec. 1039. Certain sales of low-income housing projects.
Sec. 1040. Transfer of certain farm, etc., real property.
Sec. 1041. Transfers of property between spouses or incident to divorce.
Sec. 1042. Sales of stock to employees.

PART IV—SPECIAL RULES

Sec. 1051. Property acquired during affiliation.
Sec. 1052. Basis established by the Revenue Act of 1932 or 1934 or by the Internal Revenue Code of 1939.
Sec. 1053. Property acquired before March 1, 1913.
Sec. 1054. Certain stock of Federal National Mortgage Association.
Sec. 1055. Redeemable ground rents.
Sec. 1056. Basis limitation for player contracts transferred in connection with the sale of a franchise.
Sec. 1057. Election to treat transfer to foreign trust, etc., as taxable exchange.
Sec. 1058. Transfers of securities under certain agreements.
Sec. 1059. Corporate shareholder's basis in stock reduced by nontaxed portion of extraordinary dividends.
Sec. 1060. Cross references.

Subchapter P—Capital Gains and Losses

Part I.	Treatment of capital gains.
Part II.	Treatment of capital losses.
Part III.	General rules for determining capital gains and losses.
Part IV.	Special rules for determining capital gains and losses.
Part V.	Special rules for bonds and other debt instruments.

PART I—TREATMENT OF CAPITAL GAINS

Sec. 1201.	Alternative tax.
Sec. 1202.	Deduction for capital gains.

PART II—TREATMENT OF CAPITAL LOSSES

Sec. 1211.	Limitation on capital losses.
Sec. 1212.	Capital loss carrybacks and carryovers.

PART III—GENERAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

Sec. 1221.	Capital asset defined.
Sec. 1222.	Other terms relating to capital gains and losses.
Sec. 1223.	Holding period of property.

PART IV—SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

Sec. 1231.	Property used in the trade or business and involuntary conversions.
Sec. 1233.	Gains and losses from short sales.
Sec. 1234.	Options to buy or sell.
Sec. 1234A.	Gains or losses from certain terminations.
Sec. 1235.	Sale or exchange of patents.
Sec. 1236.	Dealers in securities.
Sec. 1237.	Real property subdivided for sale.
Sec. 1238.	Amortization in excess of depreciation.
Sec. 1239.	Gain from sale of depreciable property between certain related taxpayers.
Sec. 1241.	Cancellation of lease or distributor's agreement.
Sec. 1242.	Losses on small business investment company stock.
Sec. 1243.	Loss of small business investment company.
Sec. 1244.	Losses on small business stock.
Sec. 1245.	Gain from dispositions of certain depreciable property.
Sec. 1246.	Gain on foreign investment company stock.
Sec. 1247.	Election by foreign investment companies to distribute income currently.
Sec. 1248.	Gain from certain sales or exchanges of stock in certain foreign corporations.
Sec. 1249.	Gain from certain sales or exchanges of patents, etc., to foreign corporations.
Sec. 1250.	Gain from dispositions of certain depreciable realty.
Sec. 1252.	Gain from disposition of farm land.
Sec. 1253.	Transfers of franchises, trademarks, and trade names.
Sec. 1254.	Gain from disposition of interest in oil, gas, or geothermal property.
Sec. 1255.	Gain from disposition of section 126 property.
Sec. 1256.	Section 1256 contracts marked to market.

PART V—SPECIAL RULES FOR BONDS AND OTHER DEBT INSTRUMENTS

Subpart A.	Original issue discount.
Subpart B.	Market discount.
Subpart C.	Discount on short-term obligations.
Subpart D.	Miscellaneous provisions.

Subpart A—Original Issue Discount

Sec. 1271.	Treatment of amounts received on retirement or sale or exchange of debt instruments.
Sec. 1272.	Current inclusion in income of original issue discount.
Sec. 1273.	Determination of amount of original issue discount.
Sec. 1274.	Determination of issue price in the case of certain debt instruments issued for property.
Sec. 1275.	Other definitions and special rules.

Subpart B—Market Discount on Bonds

Sec. 1276.	Disposition gain representing accrued market discount treated as ordinary income.
Sec. 1277.	Deferral of interest deduction allocable to accrued market discount.
Sec. 1278.	Definitions and special rules.

Subpart C—Discount on Short-Term Obligations

Sec. 1281.	Current inclusion in income of discount on certain short-term obligations.
Sec. 1282.	Deferral of interest deduction allocable to accrued discount.
Sec. 1283.	Definitions and special rules.

Subpart D—Miscellaneous Provisions

Sec. 1286.	Tax treatment of stripped bonds.
Sec. 1287.	Denial of capital gain treatment for gains on certain obligations not in registered form.
Sec. 1288.	Treatment of original issue discount on tax-exempt obligations.

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ATTACHMENT B

Department of the Treasury
Internal Revenue Service

1983 Package X

Informational Copies of Federal Tax Forms

Please Use Form 1040EZ

During 1983 tax practitioners prepared over 1,000,000 returns on Form 1040A and over 350,000 returns on Form 1040 that could have been prepared on Form 1040EZ. We urge you to prepare the shortest form consistent with your client's tax situation. This will enable the Internal Revenue Service to process returns more quickly and at a lower cost.

Abusive Tax Shelters

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) added new penalties for promoting abusive tax shelters. The Service is stepping up its efforts to identify and take action against abusive tax shelters. We are also actively pursuing the application of the injunctive relief provisions against promoters of abusive tax shelters.

Late-filing Penalties

Please remind your clients that they can avoid penalties for late filing by sending in their return by the due date even if they are unable to send in their full tax payment at that time. However, this will not relieve them of interest or late payment penalties that may be charged.

Penalty Under the Tax Equity and Fiscal Responsibility Act of 1982

See page 1 for an important message regarding the penalty for aiding in an understatement of tax liability.

Backup Withholding

Please remind your clients that in addition to being required to report all their taxable income, they must supply their correct taxpayer identification number to their payers of interest, dividends, commissions, etc. Otherwise, backup withholding may apply starting in 1984, and certain other penalties may apply.

The Following Forms, Instructions, and Schedules Have Been Added to Package X:

Form W-3G, Transmittal of Certain Information Returns

Form W-9, Payer's Request for Taxpayer Identification Number

Form 1040-ES, Estimated Tax for Individuals

Schedule D (Form 1065), Capital Gains and Losses

Schedule K (Form 1065), Partners' Shares of Income, Credits, Deductions, etc.

Form 1099-B, Statement for Recipients of Proceeds from Broker or Barter Exchange Transactions

Form 1099-MISC, Statement for Recipients of Miscellaneous Income

Form 1099-OID, Statement for Recipients of Original Issue Discount

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For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402
Stock Number 048-004-01382-4

Description of Some Principal Federal Tax Forms

W–2 (1983) (6-part form)

Wages and Tax Statement (For Use in Cities and States Authorizing Combined Form).

Used to report wages, tips and other compensation, third-party sick pay, allocated tips, employee FICA tax, income tax withheld, state or city income tax withheld, and to support credit shown on individual income tax return.

Emp.-IRC sec. 6051; Regs. secs. 1.6041-2 and 31.6051-1; Circular E

W–2c

Statement of Corrected Income and Tax Amounts.

Used to correct previously filed Forms W-2, W-2P, W-2AS, W-2GU, and W-2VI.

Emp.-IRC sec. 6051; Regs. sec. 1.6041-2 and 31.6051-1

W–2P (1983)

Statement For Recipients of Annuities, Pensions, Retired Pay, or IRA Payments.

Used to report annuities, pensions, and retirement pay; Federal and state income tax withheld.

Emp.-IRC sec.3405; Circular E

W–3 (1983)

Transmittal of Income and Tax Statements.

Used by employers and other payers to transmit wage and income tax withheld statements (Forms W-2 and W-2P).

Emp.-IRC sec. 6011; Regs. sec. 31.605 -2

W–3G (1983)

Transmittal of Certain Information Returns.

Used by payers of gambling winnings to transmit Form W-2G to Service Centers. Also used by payers of total distributions (those that close the account) from a pension plan, annuity, or individual retirement arrangement to transmit Form 1099R to Service Centers.

IT-IRC 3402(q), 3405, 6041, 6047, 402, and 408.

W–4 (Rev. 1-84)

Employee's Withholding Allowance Certificate.

Filed by employee with employer so that proper amount of income tax can be withheld from wages. Also used by employee to certify that he or she had no liability for income tax for preceding tax year and anticipates that no liability will be incurred for current tax year (qualifying employee will then be exempt from Federal income tax withholding).

Emp.-IRC secs. 3402(f), 3402(i), 3402(m), 3402(n); Regs. secs. 31.3402(f)(5)-1, 31.3402(n)-1; Circular E

W–5 (1984)

Earned Income Credit Advance Payment Certificate.

Used by employee to request employer to furnish advance payment of earned income credit with the employee's pay.

Emp.-IRC sec. 3507

W–9 (October 1983)

Payer's Request for Taxpayer Identification Number

Used by a payer of interest, dividends, or other payments to request payee's identification number. Payees may use this form to certify that their taxpayer identification number is correct and/or that they are not subject to backup withholding. Obsoletes Form 3435, Payer's Request for Identifying Number.

IRC secs. 3406 and 6109

706 (Rev. 11-81)

(For decedents dying before Jan. 1, 1982)

706 (Rev. 12-83 expected rev. date)

(For decedents dying after Dec. 31, 1981)

United States Estate Tax Return.

Used for the estate of a deceased United States resident or citizen.

E&G-IRC sec. 6018; Regs. sec. 20.6018-1; Separate instructions

709 (Rev. 12-83 expected rev. date)

United States Gift Tax Return.

Used to report gifts made after Dec. 31, 1981, in excess of $10,000, and gifts of a future interest in property regardless of value.

E&G-IRC sec. 6019; Regs. sec. 25.6019-1; Separate instructions

709–A (Rev. 7-82)

United States Short Form Gift Tax Return.

Used by married couples to report nontaxable gifts of $20,000 or less per donee.

E&G-IRC sec. 2513; Regs. sec. 25.2513-2

712 (Rev. 9-83)

Life Insurance Statement.

Used with Form 706 or Form 709.

E&G-IRC secs. 6001 and 6018; Regs. secs. 20.6001-1, 20.6018-4(d), 25.6001-1

940 (1983)

Employer's Annual Federal Unemployment Tax Return.

Used by employers to report FUTA tax. A two-part set containing an original and duplicate copy of Form 940, with instructions for preparation.

Emp.-IRC sec. 6011; IRC Chapter 23; Regs. sec. 31.6011(a)-3; Circular E

941c (Rev. 7-82)

Statement to Correct Information Previously Reported on the Employer's Federal Tax Return.

Used to correct FICA wage, FICA tax and income tax reports previously submitted by employers.

Emp.-IRC Chapter 21; Regs. secs. 31.6011(a)-1, 31.6205-1, 31.6402(a)-2; Circulars A and E

943 (1983)

Employer's Annual Tax Return for Agricultural Employees.

Used by agricultural employers to report FICA and income taxes withheld.

Emp.-IRC secs. 3101, 3111 and 3402; Regs. sec. 31.6011(a)-1; Circular A

990 (1983)

Return of Organization Exempt From Federal Income Tax (Except Private Foundation).

Used by organizations exempt under IRC section 501(a) and described in section 501(c) other than private foundations. (An information return).

IT-IRC sec. 6033; Regs. sec. 1.6033-1(a)(2); Separate instructions

Schedule A (Form 990) (1983)

Organization Exempt Under 501(c)(3) (Supplementary Information).

Used by organizations described in IRC section 501(c)(3) (other than private foundations filing Form 990-PF).

IT-IRC sec. 6033; Separate instructions

990–C (1983)

Farmers' Cooperative Association Income Tax Return.

Used by Farmers' Cooperative Marketing and Purchasing Associations.

IT-IRC secs. 521, 522, 1381, 1382, 1383, 1385, 1388, 6012; Regs. secs. 1.521-1, 1.522-1, 1.1381-1, 2, 1.1382-1, 2, 3, 4, 5, 6, 7, 1.1383-1, 1.1385-1, 1.1388-1, 1.6012-2(f); Separate instructions

990–PF (1983)

Return of Private Foundation or Section 4947(a)(1) Trust Treated as a Private Foundation.

Used by private foundations and section 4947(a)(1) trusts. (An information return.)

IT-IRC sec. 6033; IRC Chapter 42, Regs. sec. 1.6033-2; Separate instructions

990–T (1983)

Exempt Organization Business Income Tax Return.

Used by exempt organization with unrelated business income (under section 511 of the IRC).

IT-IRC secs. 511 and 6012; Regs. secs. 1.6012-2(e), 1.6012-3(a)(5); Separate instructions

1040 (1983)

U.S. Individual Income Tax Return.

Used by citizens and residents of the United States to report income tax. Also see Form 1040A and Form 1040EZ.

IT-IRC secs. 6012 and 6017; Regs. secs. 1.142-1, 1.6012-1, and 1.6017-1; Pub. 17; Separate instructions

Sch. A (Form 1040) (1983)

Itemized Deductions.

Used to report itemized deductions (medical and dental expenses, taxes, contributions, interest, casualty and theft losses, and miscellaneous deductions).

IT-IRC secs. 163, 164, 165, 170, 211, 212, 213 and 222; Pub. 17; Separate instructions

Sch. B (Form 1040) (1983)

Interest and Dividend Income.

Used to list gross dividends (if in excess of $400), to exclude stock dividends from a reinvestment plan of a qualified public utility, to report any interest from an All-Savers Certificate, and to report other interest income (if in excess of $400) received. Also used to answer questions about Foreign Accounts and Foreign Trusts.

IT-IRC secs. 61, 116, 128, 305(e) and 6012; Pub. 17; Separate instructions

Sch. C (Form 1040) (1983)

Profit or (Loss) from Business or Profession.

Used to compute profit (or loss) from business or profession.

IT-IRC sec. 6017; Regs. sec. 1.6017-1; Pubs. 17 and 334; Separate instructions

Sch. D (Form 1040) (1983)

Capital Gains and Losses.

Used to report details of gain (or loss) from sales and exchanges of capital assets and to compute post-1969 capital loss carryovers from 1983 to 1984.

IT-IRC secs. 1202-1223; Pubs. 17 and 334; Separate instructions

Sch. E (Form 1040) (1983)

Supplemental Income Schedule.

Used to report income from rents, royalties, partnerships, S corporations, estates, and trusts.

IT-IRC secs. 6012 and 6017; Regs. secs. 1.6012-1 and 1.6017-1; Pub. 17; Separate instructions

Sch. F (Form 1040) (1983)

Farm Income and Expenses.

Used to compute profit (or loss) from farming.

IT-IRC sec. 6012; Regs. sec 1.61-4; Pub. 225; Separate instructions

Sch. G (Form 1040) (1983)

Income Averaging.

Used to determine whether tax computed under the averaging provisions is the most advantageous method.

IT-IRC secs. 1301 and 1305

Sch. R&RP (Form 1040) (1983)

Credit for the Elderly.

Used to compute the credit for the elderly for individuals 65 or over and individuals under 65 having Public Retirement System Income.

IT-IRC sec. 37; Pub. 17; Separate instructions

Sch. SE (Form 1040) (1983)

Computation of Social Security Self-Employment Tax.

Used to compute self-employment tax.

IT-IRC secs. 1401 and 1402; Separate instructions

Sch. W (Form 1040) (1983)

Deduction for a Married Couple When Both Work.

Used to compute the deduction allowed to a married couple filing jointly when both have qualified earned income.

IT-IRC sec. 221; Pub. 17

1040A (1983)

U.S. Individual Income Tax Return.

Used by citizens and residents of the United States to report income tax.

IT-IRC sec. 6012; Regs. sec. 1.6012-1; Separate instructions

1040-ES (1984)

Estimated Tax for Individuals.

Used to make estimated tax payments as a means for paying currently any income tax (including self-employment tax) due in excess of the tax withheld from wages, salaries, and other payments for personal services. It is not required unless the total tax exceeds withholding (if any) and applicable tax credits by $400 or more.

IT-IRC sec. 6015; Regs. sec. 1.6015(d)-1

1040EZ (1983)

Income Tax Return for Single Filers with No Dependents.

Used by citizens and residents of the United States to report income tax. Also see Form 1040A.

IT-IRC sec. 6012; Regs. sec. 1.6012-1; Separate instructions

1040NR (1983)

U.S. Nonresident Alien Income Tax Return.

Used by all nonresident alien individuals who file a U.S. tax return, whether or not engaged in a trade or business within the United States. Also used as required for filing nonresident alien fiduciary (Estate and Trust) returns.

IT-IRC secs. 871 and 6012; Pub. 519; Separate instructions

1040X (Rev. 10-83)

Amended U.S. Individual Income Tax Return.

Used to claim refund of income taxes, pay additional income taxes, or designate dollar(s) to a Presidential Election Campaign fund.

IT-IRC secs. 6402, 6404, 6511, and 6096; Separate instructions

1041 (1983)

U.S. Fiduciary Income Tax Return (For Estates and Trusts).

Used by a fiduciary for domestic estate or domestic trust. (An annual return.)

IT-IRC sec. 6012; Regs. secs. 1.671-4, 1.6012-3(a); Separate instructions

Sch. D (Form 1041) (1983)

Capital Gains and Losses.

Used to report details of gain (or loss) from sales or exchanges of capital assets.

IT-IRC sec. 6012; Regs. sec. 1.6012-3; Separate instructions

Sch. K–1 (Form 1041) (1983)

Beneficiary's Share of Income, Deductions, Credits, etc.

Used to report each beneficiary's share of the income, deductions, credits, and items of tax preference from the estate or trust.

IT-IRC sec. 6012; Regs. sec. 1.6012-3(a)

Sch. J (Form 1041) (1983)

Trust Allocation of an Accumulation Distribution (IRC Section 665).

Used for domestic complex trusts.

IT-IRC secs. 665, 666, and 667

1065 (1983)

U.S. Partnership Return of Income.

Used by partnerships as an information return.

IT-IRC secs. 6031 and 6698; Regs. secs. 1.761-1(a), 1.6031-1; Separate instructions

Sch. D (Form 1065) (1983)

Capital Gains and Losses

Used to show partnership capital gains and losses that are not specially allocated.

IT-IRC secs. 1202-1223

Sch. K (Form 1065) (1983)

Partners' Share of Income, Credits, Deductions, etc.

Used to show partners' share of income, credits, deductions, etc. if more than 10 Schedules K-1 (Form 1065).

IT-IRC sec. 702

Sch. K–1 (Form 1065) (1983)

Partner's Share of Income, Credits, Deductions, etc.

Used to show partner's share of income, credits, deductions, etc. A four-part assembly—one copy is filed with Form 1065, one copy is for partnership records, and one copy is given to each partner. The last page is instructions for the partner.

IT-IRC sec. 702

1096 (1983)

Annual Summary and Transmittal of U.S. Information Returns.

Used for summarizing and transmitting reports on Forms 1099-ASC, 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, and 5498.

IT-IRC secs. 408(i), 6041, 6042, 6043, 6044, 6045, 6049, 6050A, 6050B, 6050E; Separate instructions

1099–B (1983)

Statement for Recipients of Proceeds from Broker or Barter Exchange Transactions.

Used to report proceeds from the sale or redemption of securities, commodities, futures contracts, or exchanges of goods or services by a barter exchange.

IT-IRC sec. 6045

1099–DIV (1983)

Statement for Recipients of Dividends and Distributions.

Used to report dividends and distributions (including distributions in liquidation).

IT-IRC secs. 6042 and 6043

1099–G (1983)

Statement for Recipients of Certain Government Payments.

Used by Federal, State, or local governments to report payments of unemployment compensation; State and local income tax refunds, offsets, or credits; discharges of indebtedness; taxable grants; or agriculture subsidy payments (including PIK).

IT-IRC secs. 6041, 6050B, and 6050E

1099–INT (1983)

Statement for Recipients of Interest Income.

Used to report interest income (including interest on bearer certificates of deposit).

IT-IRC secs. 6041 and 6049

1099–MISC (1983)

Statement for Recipients of Miscellaneous Income.

Used to report rents, royalties, prizes and awards, fishing boat proceeds, medical and health care payments by medical and health care insurers, nonemployee compensation, and direct sales of $5,000 or more.

IT-IRC secs. 6041, 6041A, and 6050A; Rev. Rul. 69-595, 1969-2, C.B. 242, and Rev. Rul. 70-608, 1970-2 C.B. 286

1099–OID (1983)

Statement for Recipients of Original Issue Discount.

Used to report original issue discount.

IT-IRC secs. 6049 and 1232

1099–PATR (1983)

Statement for Recipients (Patrons) of Taxable Distributions Received from Cooperatives.

Used to report patronage dividends.

IT-IRC sec. 6044

1099R (1983)

Statement for Recipients of Total Distributions from Profit-Sharing, Retirement Plans, and Individual Retirement Arrangements.

Used to report total distributions from profit sharing, retirement plans, and individual retirement arrangements.

IT-IRC secs. 6047, 402, 408

1116 (1983)

Computation of Foreign Tax Credit-Individual, Fiduciary, or Nonresident Alien Individual.

Used to figure and support the foreign tax credit claimed for the amount of any income, war profits, and excess profits taxes paid or accrued during the tax year to any foreign country or U.S. possession.

IT-IRC secs. 901 and 904; Pub. 514; Separate instructions

Sch. A (Form 1116) (1983)

Schedule of Foreign Taxable Income and Foreign Taxes Paid or Accrued.

Used as an attachment to Form 1116, Computation of Foreign Tax Credit—Individual, Fiduciary, or Nonresident Alien Individual, to figure and support the foreign tax credit claimed when income has been derived from, or taxes have been paid to, more than one foreign country or U.S. possession.

IT-IRC secs. 901 and 904; Pub. 514; Separate instructions

1120 (1983)

U.S. Corporation Income Tax Return.

Used by a corporation to report income tax.

IT-IRC sec. 6012; Regs. secs. 1.1502-75(b), 1.831-3(c), 1.6012-2; Separate instructions

Sch. D (Form 1120) (1983)

Capital Gains and Losses.

Used by a taxpayer who files either Forms 1120, 1120-DISC, 1120F, 1120-H, 1120L, 1120M, 1120-POL, 990-C, or certain Forms 990-T, to report details of gain (or loss) from sales or exchanges of capital assets, and to figure the alternative tax.

IT-IRC secs. 1201 and 1231

Sch. PH (Form 1120) (1983)

Computation of U.S. Personal Holding Company Tax.

Used to compute personal holding company tax; filed with the income tax return of every personal holding company.

IT-IRC secs. 541, 6012, 6501(f)

1120–DISC (1983)

Domestic International Sales Corporation Return.

Used for a tax year relating to a DISC.

IT-IRC secs. 6011(c), 6072(b); Separate instructions

Sch. K (Form 1120–DISC) (1983)

Shareholder's Statement of DISC Distribution.

Used to report deemed and actual distributions from a DISC to shareholders.

IT-IRC sec. 6011(c)

Sch. N (Form 1120–DISC) (1983)

Export Gross Receipts of the DISC and Related U.S. Persons.

Used to report geographic source of gross receipts of the DISC and certain related persons.

IT-IRC sec. 6011(c); Separate instructions

1120F (1983)

U.S. Income Tax Return of a Foreign Corporation.

Used by foreign corporations to report income tax.

IT-IRC secs. 881, 882, and 6012; Separate instructions

1120S (1983)

U.S. Income Tax Return for an S Corporation.

Used by S corporations to report taxes under Subchapter S of the IRC and as an information return.

IT-IRC sec. 6037, Subchapter S; Regs. sec. 1.6037-1; Separate instructions

Sch. D (Form 1120S) (1983)

Capital Gains and Losses.

Used by S corporations to report details of gains (and losses) from sales or exchanges of capital assets and to figure the tax imposed on certain capital gains.

IT-IRC secs. 1201, 1231, and IRC Subchapter S

Sch. K–1 (Form 1120S) (1983)

Shareholder's Share of Income, Credits, Deductions, etc.

Used to show shareholder's share of income, credits, deductions, etc. A four-part assembly: One copy is filed with Form 1120S, one copy is for corporate records, and one copy is given to each shareholder. The last sheet is instructions for the shareholder.

IT-IRC sec. 6037; Regs. sec. 1.6037-1

1120–W (Worksheet) (1984)

Corporation Estimated Tax.

Used as a worksheet by corporations to compute estimated tax liability; not required to be filed. Corporations should keep it for their records.

IT-IRC sec. 6154

1120X (Rev. 10–83)

Amended U.S. Corporation Income Tax Return.

Used by corporations to amend a previously filed Form 1120.

IT-Regs. sec. 301.6402-3

1139 (Rev. 11–83)

Corporation Application for Tentative Refund.

Used by corporations which have certain carrybacks and desire a quick refund of taxes.

IT-IRC sec. 6411

1310 (Rev. 8–81)

Statement of Person Claiming Refund Due a Deceased Taxpayer.

Used by a claimant to secure payment of refund on behalf of a deceased taxpayer.

IT-IRC sec. 6402; Regs. sec. 301.6402-2(e)

2106 (1983)

Employee Business Expenses.

For optional use to support deductions from income tax for travel, transportation, outside salesperson and educational expenses (except moving expenses).

IT-IRC secs. 162 and 274

2119 (1983)

Sale or Exchange of Principal Residence.

For use by individuals who sold their principal residence. Also used by those individuals 55 or older who elect to exclude gain on the sale of their principal residence.

IT-IRC secs. 121 and 1034; Pub. 17

2120 (Rev. 9–81)

Multiple Support Declaration.

Used as a statement disclaiming as an income tax exemption an individual to whose support the taxpayer and others have contributed.

IT-IRC sec. 152(c); Regs. sec. 1.152-3(c); Pub. 17

2210 (1983)

Underpayment of Estimated Tax by Individuals.

Used by individuals to see if they paid enough estimated tax. It is also used to see if any of the exceptions to the penalty for underpayment of estimated tax are met and, if not, to figure the penalty.

IT-IRC sec. 6654; Regs. sec. 1.6654-1; Pub. 505

2220 (1983)

Underpayment of Estimated Tax by Corporations.

Used by a corporation to determine whether it paid enough estimated tax, whether it is subject to the penalty for underpayment of estimated tax, and how much penalty it may owe for any underpayment.

(If additional tax is due, a computation schedule is provided.)

IT-IRC sec. 6655; Regs. sec. 1.6655-1(b)

2350 (1983)

Application for Extension of Time to File U.S. Income Tax Return.

Used by U.S. citizens and U.S. resident aliens abroad who expect to qualify for special tax treatment to obtain an extension of time for filing an income tax return.

IT-IRC secs. 911and 6081; Pub. 54

2440 (1983)

Disability Income Exclusion.

Used to compute amount of disability income exclusion.

IT-IRC sec. 105; Instructions for Form 1040; Pubs. 17 and 522

2441 (1983)

Credit for Child and Dependent Care Expenses.

Used to support credit for child and dependent care expenses. (To be attached to Form 1040.)

IT-IRC sec. 44A; Regs. sec. 1.44A-1; Inst. for Form 1040; Pubs. 17 and 503

2555 (1983)

Foreign Earned Income.

Used by U.S. citizens and U.S. resident aliens who qualify for the foreign earned income exclusion or the housing exclusion or deduction.

IT-IRC sec. 911; Pub. 54; Separate instructions

2688 (1983)

Application for Extension of Time to File U.S. Individual Income Tax Return.

Used to apply for an additional extension of time to file Form 1040 or 1040A.

IT-IRC sec. 6081; Regs. sec. 1.6081-1(b)

2758 (Rev. 10–83)

Application for Extension of Time to File U.S. Partnership, Fiduciary, and Certain Exempt Organization Returns.

Used to apply for an extension of time to file Form 1065, Form 1041, and certain exempt organization returns.

IT-IRC sec. 6081; Regs. sec. 1.6081-1(b)

2848 (Rev. 10–83)

Power of Attorney and Declaration of Representative.

Used as an authorization for one person to act for another in any tax matter (except alcohol and tobacco taxes and firearms activities).

IT-Title 26, CFR, Part 601; Separate instructions

3468 (1983)

Computation of Investment Credit.

Used by individuals, estates, trusts, and corporations claiming a regular or business energy investment credit.

IT-IRC secs. 38, 46, 47, and 48; Separate instructions

3903 (1983)

Moving Expense Adjustment.

For optional use to support deductions from income for expenses of travel, transportation (including meals and lodging), and certain expenses of selling an old residence and buying a new residence for employees or self-employed individuals moving to a new job location in the U.S. or its possessions.

IT-IRC sec. 217; Regs. sec. 1.217; Pub. 521

4136 (1983)

Computation of Credit for Federal Tax on Gasoline, Special Fuels, and Lubricating Oil.

Used by individuals, estates, trusts, or corporations, including S corporations and domestic international sales corporations, to claim credit for Federal excise tax on the number of gallons of gasoline, special fuels, and lubricating oil used in business (including qualified taxicabs).

Ex-IRC secs. 39, 4041, 4081, 6420, 6421, 6424, and 6427

4137 (1983)

Computation of Social Security Tax on Unreported Tip Income.

Filed by an employee who received tips subject to social security tax but failed to report them to his or her employer.

Emp.-IRC sec. 3102; Regs. Secs. 31.3102-3(d), 31.6011(a)-1(d)

4255 (Rev. 11–82)

Recapture of Investment Credit.

Used by individuals, estates, trusts, or corporations to recapture the regular or energy investment credit taken on property disposed of before the end of the useful life or recovery period used in computing the credit. The tax must be increased if the credit allowed is more than the credit allowable at the time of disposition.

IT-IRC sec. 47; Regs. sec. 1.47-1

4466 (1983)

Corporation Application for Quick Refund of Overpayment of Estimated Tax.

Used to apply for a "quick" refund of overpaid estimated tax. (Must be filed before the regular tax return is filed.)

IT-IRC sec. 6425; Regs. sec. 1.6425-1(b)

4562 (Rev. 9–83)

Depreciation and Amortization.

For use by individuals, estate and trusts, partnerships, and corporations claiming depreciation or amortization.

IT-IRC secs. 58 (i),167, 168, 169, 174, 177, 179, 185, 188, 189, 191 (as before repeal by Public Law 97-34), 194, 195, 248, and 709

4626 (1983)

Computation of Minimum Tax—Corporations.

Used generally by corporations to compute minimum tax when tax preferences are more than $10,000.

IT-IRC secs. 56, 57, and 58

4684 (1983)

Casualties and Thefts.

For use by all taxpayers for reporting gains and losses from casualties and thefts.

IT-IRC secs. 165 and 1231; Separate instructions

4782 (Rev. 8–83)

Employee Moving Expense Information.

Used by employers to show employees the amount of any reimbursement or payment made to an employee, a third party for the employee's benefit, or the value of services furnished in-kind, for moving expenses during the calendar year.

IT-IRC secs. 82 and 217; Regs. sec. 31.6051-1(e)

4797 (1983)

Supplemental Schedule of Gains and Losses.

Used to report details of gain (or loss) from sales, exchanges, or involuntary conversions (other than casualties and thefts) of noncapital assets and involuntary conversions of capital assets (other than casualties and thefts) held for more than one year.

IT-IRC secs. 1231, 1245, 1250, 1251, 1252, 1254 and 1255; Separate instructions

4798 (1983)

Carryover of Pre-1970 Capital Losses.

Used by an individual to figure the capital loss limitation if pre-1970 losses are involved, and any capital loss carryover from the current tax year to the following tax year.

IT-IRC secs. 1211 and 1212

4835 (1983)

Farm Rental Income and Expenses.

Used by landowner (or sublessor) to report farm rental income based on crops or livestock produced by the tenant where the landowner (or sublessor) does not materially participate in the operation or management of the farm.

IT-IRC sec. 61

4868 (1983)

Application for Automatic Extension of Time to File U.S. Individual Income Tax Return.

Used to apply for an automatic 4-month extension of time to file Form 1040 or 1040A.

IT-IRC sec. 6081; Regs. sec. 1.6081-4

4952 (1983)

Investment Interest Expense Deduction.

Used by an individual, estate, or trust to compute the deduction limitation for interest expense on funds borrowed to purchase or carry property held for investment.

IT-IRC sec. 163(d)

4970 (1983)

Tax on Accumulation Distribution of Trusts.

For use by a beneficiary of a domestic or foreign trust to compute the tax attributable to an accumulation distribution.

IT-IRC sec. 667

4972 (1983)

Special 10-Year Averaging Method.

Used to determine the income tax on the ordinary income portion of lump-sum distributions.

IT-IRC sec. 402(e); Separate instructions

5329 (1983)

Return for Individual Retirement Arrangement Taxes.

Used to report the various individual retirement arrangement taxes under sections 408(f), 409(c), 4973, and 4974.

5330 (Rev. 12–83)

Return of Initial Excise Taxes Related to Pension and Profit-Sharing Plans.

Used to report excise taxes imposed by IRC sections 4971, 4973(a)(2) and 4975.

5498 (1983)

Individual Retirement Arrangement Information.

Used to report calendar year contributions to IRAs or SEPs.

IT-IRC sec. 408(i)

5500 (1983)

Annual Return/Report of Employee Benefit Plan.

Used to report on deferred compensation plans and welfare plans that have at least 100 participants.

IT-IRC sec. 6058(a); ERISA section 103

Sch. A (Form 5500) (1983)

Insurance Information.

Used as an attachment to Forms 5500, 5500-C, or 5500-K to report information about insurance contracts that are part of a qualified deferred compensation plan.

IT-ERISA section 103(e)

Sch. B (Form 5500) (1983)

Actuarial Information.

Used to report actuarial information with respect to a defined benefit plan. It is attached to Form 5500, 5500-C, or 5500-K.

IT-IRC sec. 6059; ERISA sec. 103(a)

Sch. P (Form 5500) (1983)

Annual Return of Fiduciary of Employee Benefit Trust.

Used as an attachment to Forms 5500, 5500-C, 5500-G, 5500-K and 5500-R to satisfy reporting requirements under IRC section 6033(a) and start statute of limitations under IRC section 6501(a).

IT-IRC secs. 6033(a) and 6501(a)

Sch. SSA (Form 5500) (1983)

Registration Statement Identifying Separated Participants with Deferred Vested Benefits.

Used as an attachment to Forms 5500, 5500-C, or 5500-K to list the employees who separated from employment and have a deferred vested benefit in the employer's plan of deferred compensation.

IT-IRC sec. 6057

5500–C (1983)

Return/Report of Employee Benefit Plan.

Used to report on deferred compensation plans and welfare plans that have fewer than 100 participants, none of whom is an owner-employee.

IT-IRC sec. 6058(a); ERISA sec. 103

5500–K (1983)

Return/Report of Employee Pension Benefit Plan for Sole Proprietorships and Partnerships.

Used to report on H.R. 10 (Keogh) plans that have fewer than 100 participants and at least one owner-employee participant.

IT-IRC sec. 6058(a); ERISA sec. 103

5500–R (1983)

Registration Statement of Employee Benefit Plan.

Used to report on deferred compensation plans and welfare plans that have fewer than 100 participants. This form is filed for plan years when Form 5500-C or 5500-K is not required to be filed.

IT-IRC sec. 6058(a); ERISA sec. 103

5544 (1983)

Multiple Recipient Special 10-Year Averaging Method.

Used to determine income tax on the ordinary income portion of lump-sum distributions received by a multiple recipient.

IT-IRC sec. 402(e); Separate instructions

5558 (Rev. 10–82)

Application for Extension of Time to File Certain Employee Plan Returns.

Used to request an extension of time to file Forms 5500, 5500-C, 5500-K, 5500-R and 5330.

IRC sec. 6081(a)

5695 (1983)

Residential Energy Credit.

Used by individual taxpayers to claim a credit against their tax for qualified energy-saving property.

IT-IRC sec. 44C

5884 (1983)

Jobs Credit (and WIN credit carryover).

Used by individuals, estates, trusts, and corporations claiming a jobs credit or WIN credit carryover, and any S corporation, partnership, estate, or trust which apportions the credits among its shareholders, partners, or beneficiaries.

IT-IRC secs. 44B, 51, 52, and 53

6198 (1983)

Computation of Deductible Loss from an Activity Described in Section 465(c).

Used by taxpayers to determine the overall profit (loss) from an at-risk activity, the amount at risk, and the deductible loss.

IT-IRC sec. 465; Separate instructions

6251 (1983)

Alternative Minimum Tax Computation.

Used by individuals, estates, and trusts to report tax preference items and to compute their alternative minimum tax liability.

IT-IRC secs. 55 and 57

6252 (1983)

Computation of Installment Sale Income.

Used by taxpayers other than dealers, who sell real or personal property, and receive any payment from the sale in a tax year after the year of sale.

IT-IRC sec. 453; Pub. 537

6765 (1983)

Credit for Increasing Research Activities (or for claiming the orphan drug credit).

Used by individuals, estates, trusts, and corporations to claim a credit for increasing research activities for a trade or business. Also used to claim the orphan drug credit.

IT-IRC secs. 44F and 44H; Pub. 906

6781 (1983)

Gains and Losses from Regulated Futures Contracts and Straddles.

Used by all taxpayers that held regulated futures contracts or straddles during the tax year.

IT-IRC secs. 1092 and 1256

7004 (Rev. 10–83)

Application for Automatic Extension of Time to File Corporation Income Tax Return.

Used by corporations and certain exempt organizations to request an automatic extension of 6 months to file its income tax return.

IT-IRC sec. 6081(b); Regs. sec. 1.6081-3

8027 (1983)

Employer's Annual Information Return of Tip Income and Allocated Tips.

Used by large food or beverage establishments to report certain receipts from food or beverage operations, tips reported by employees, and in certain cases, tips allocated to employees.

IT-IRC sec. 6053(c)

Treasury Department Form 90–22.1 (Rev. 9–83)

Report of Foreign Bank and Financial Accounts.

Filed by any individual, trust, partnership, or corporation that has a financial interest in, or signature authority or other authority over, bank, securities, or other financial accounts in a foreign country, that exceeded $5,000 in aggregate value at any time during the calendar year.

P.L. 91-508; Treasury Regs. (31 CFR 103)

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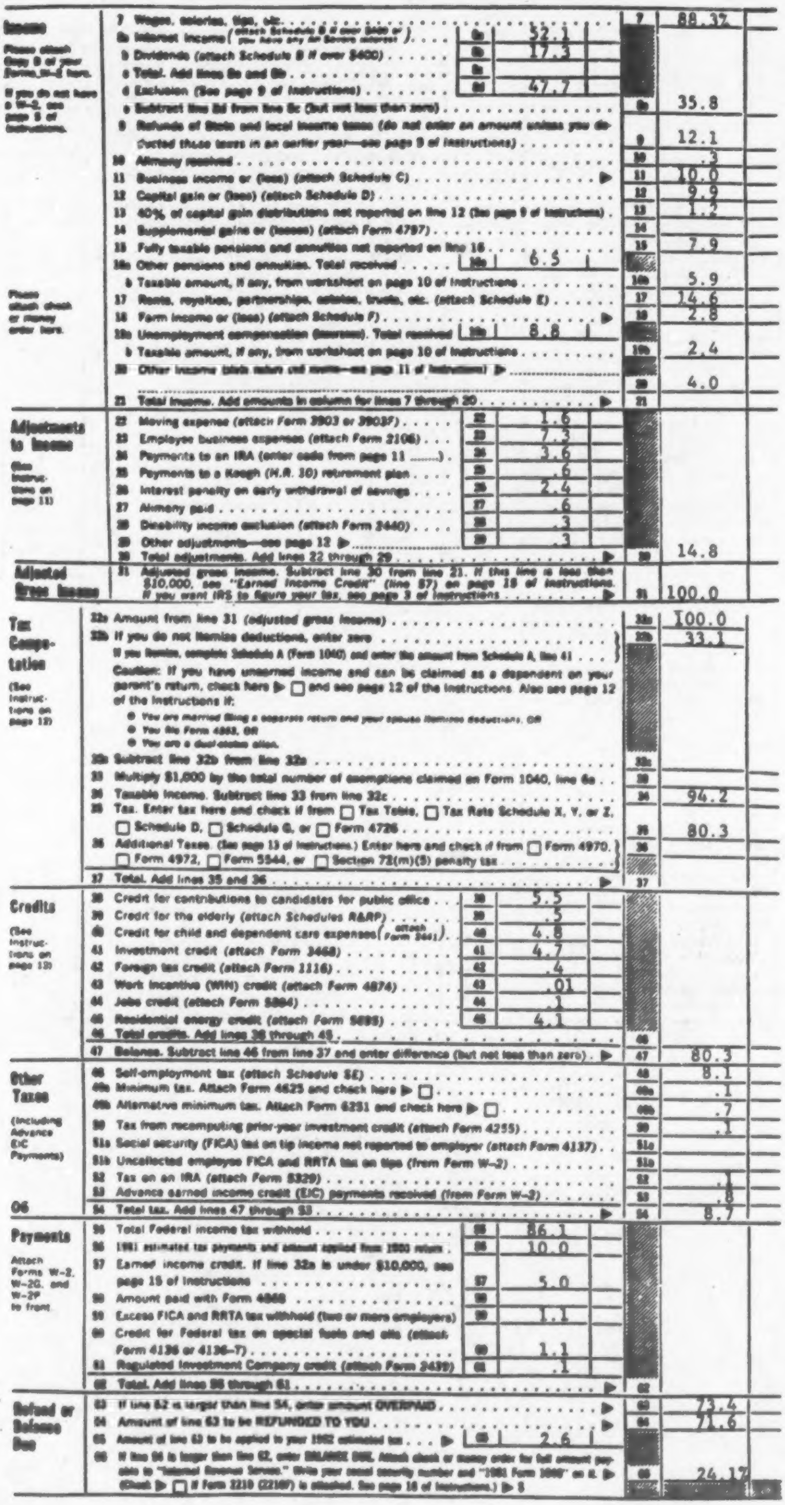
ATTACHMENT C: PERCENTAGE OF INDIVIDUAL TAXPAYERS REPORTING
SELECTED ITEMS ON TAX RETURNS, 1981



	Line	Item	Box		Line	
Income Please attach Copy B of your Forms W-2 here. If you do not have a W-2, see page 5 of Instructions.	7	Wages, salaries, tips, etc.			7	88.37
	8a	Interest income (attach Schedule B if over $400 or you have any All-Savers interest)	8a	52.1		
	b	Dividends (attach Schedule B if over $400)	8b	17.3		
	c	Total. Add lines 8a and 8b	8c			
	d	Exclusion (See page 9 of Instructions)	8d	47.7		
	e	Subtract line 8d from line 8c (but not less than zero)			8e	35.8
	9	Refunds of State and local income taxes (do not enter an amount unless you deducted those taxes in an earlier year—see page 9 of Instructions)			9	12.1
	10	Alimony received			10	.3
	11	Business income or (loss) (attach Schedule C) ▶			11	10.0
	12	Capital gain or (loss) (attach Schedule D)			12	9.9
	13	40% of capital gain distributions not reported on line 12 (See page 9 of Instructions)			13	1.2
	14	Supplemental gains or (losses) (attach Form 4797)			14	
	15	Fully taxable pensions and annuities not reported on line 16			15	7.9
	16a	Other pensions and annuities. Total received	16a	6.5		
	b	Taxable amount, if any, from worksheet on page 10 of Instructions			16b	5.9
Please attach check or money order here.	17	Rents, royalties, partnerships, estates, trusts, etc. (attach Schedule E)			17	14.6
	18	Farm income or (loss) (attach Schedule F) ▶			18	2.8
	19a	Unemployment compensation (insurance). Total received	19a	8.8		
	b	Taxable amount, if any, from worksheet on page 10 of Instructions			19b	2.4
	20	Other income (state nature and source—see page 11 of Instructions) ▶			20	4.0
	21	Total income. Add amounts in column for lines 7 through 20 ▶			21	
Adjustments to Income (See Instructions on page 11)	22	Moving expense (attach Form 3903 or 3903F)	22	1.6		
	23	Employee business expenses (attach Form 2106)	23	7.3		
	24	Payments to an IRA (enter code from page 11 ......)	24	3.6		
	25	Payments to a Keogh (H.R. 10) retirement plan	25	.6		
	26	Interest penalty on early withdrawal of savings	26	2.4		
	27	Alimony paid	27	.6		
	28	Disability income exclusion (attach Form 2440)	28	.3		
	29	Other adjustments—see page 12 ▶	29	.3		
	30	Total adjustments. Add lines 22 through 29 ▶			30	14.8
Adjusted Gross Income	31	Adjusted gross income. Subtract line 30 from line 21. If this line is less than $10,000, see "Earned Income Credit" (line 57) on page 15 of Instructions. If you want IRS to figure your tax, see page 3 of Instructions ▶			31	100.0
Tax Compu-tation (See Instructions on page 12)	32a	Amount from line 31 (adjusted gross income)			32a	100.0
	32b	If you do not itemize deductions, enter zero If you itemize, complete Schedule A (Form 1040) and enter the amount from Schedule A, line 41 Caution: If you have unearned income and can be claimed as a dependent on your parent's return, check here ▶ ☐ and see page 12 of the Instructions. Also see page 12 of the Instructions if: ● You are married filing a separate return and your spouse itemizes deductions, OR ● You file Form 4563, OR ● You are a dual-status alien.			32b	33.1
	32c	Subtract line 32b from line 32a			32c	
	33	Multiply $1,000 by the total number of exemptions claimed on Form 1040, line 6e			33	
	34	Taxable income. Subtract line 33 from line 32c			34	94.2
	35	Tax. Enter tax here and check if from ☐ Tax Table, ☐ Tax Rate Schedule X, Y, or Z, ☐ Schedule D, ☐ Schedule G, or ☐ Form 4726			35	80.3
	36	Additional Taxes. (See page 13 of Instructions.) Enter here and check if from ☐ Form 4970, ☐ Form 4972, ☐ Form 5544, or ☐ Section 72(m)(5) penalty tax			36	
	37	Total. Add lines 35 and 36 ▶			37	
Credits (See Instructions on page 13)	38	Credit for contributions to candidates for public office	38	5.5		
	39	Credit for the elderly (attach Schedules R&RP)	39	.5		
	40	Credit for child and dependent care expenses (attach Form 2441)	40	4.8		
	41	Investment credit (attach Form 3468)	41	4.7		
	42	Foreign tax credit (attach Form 1116)	42	.4		
	43	Work Incentive (WIN) credit (attach Form 4874)	43	.01		
	44	Jobs credit (attach Form 5884)	44	.1		
	45	Residential energy credit (attach Form 5695)	45	4.1		
	46	Total credits. Add lines 38 through 45			46	
	47	Balance. Subtract line 46 from line 37 and enter difference (but not less than zero) ▶			47	80.3
Other Taxes (Including Advance EIC Payments)	48	Self-employment tax (attach Schedule SE)			48	8.1
	49a	Minimum tax. Attach Form 4625 and check here ▶ ☐			49a	.1
	49b	Alternative minimum tax. Attach Form 6251 and check here ▶ ☐			49b	.7
	50	Tax from recomputing prior-year investment credit (attach Form 4255)			50	.1
	51a	Social security (FICA) tax on tip income not reported to employer (attach Form 4137)			51a	
	51b	Uncollected employee FICA and RRTA tax on tips (from Form W-2)			51b	
	52	Tax on an IRA (attach Form 5329)			52	.1
	53	Advance earned income credit (EIC) payments received (from Form W-2)			53	.8
06	54	Total tax. Add lines 47 through 53 ▶			54	8.7
Payments Attach Forms W-2, W-2G, and W-2P to front.	55	Total Federal income tax withheld	55	86.1		
	56	1981 estimated tax payments and amount applied from 1980 return	56	10.0		
	57	Earned income credit. If line 32a is under $10,000, see page 15 of Instructions	57	5.0		
	58	Amount paid with Form 4868	58			
	59	Excess FICA and RRTA tax withheld (two or more employers)	59	1.1		
	60	Credit for Federal tax on special fuels and oils (attach Form 4136 or 4136-T)	60	1.1		
	61	Regulated Investment Company credit (attach Form 2439)	61	.1		
	62	Total. Add lines 55 through 61 ▶			62	
Refund or Balance Due	63	If line 62 is larger than line 54, enter amount OVERPAID ▶			63	73.4
	64	Amount of line 63 to be REFUNDED TO YOU ▶			64	71.6
	65	Amount of line 63 to be applied to your 1982 estimated tax ▶	65	2.6		
	66	If line 54 is larger than line 62, enter BALANCE DUE. Attach check or money order for full amount payable to "Internal Revenue Service." Write your social security number and "1981 Form 1040" on it. ▶ (Check ▶ ☐ if Form 2210 (2210F) is attached. See page 16 of Instructions.) ▶ $			66	24.17

Table 9.--All Returns: Percentage Distribution of Selected Forms and Schedules, Classified by Size of Adjusted Gross Income, Tax Year 1982

Schedule or Form	Type of attachment	Total	Percentage of returns by size of adjusted gross income						
			Under $5,000	$5,000 under $10,000	$10,000 under $15,000	$15,000 under $20,000	$20,000 under $30,000	$30,000 under $50,000	$50,000 and over
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	All Form 1040 returns filed	54,687	4,445	6,836	6,794	6,850	12,561	13,503	3,699
	Percent	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
A	Itemized Deductions	57.4	13.6	23.4	37.3	47.0	66.1	86.0	95.4
B	Interest and Dividend Income	46.6	43.7	47.5	45.7	40.7	39.4	49.0	77.2
C	Profit or (Loss) From Business or Profession	16.4	25.3	20.8	15.1	13.8	14.9	13.8	19.8
D	Capital Gains and Losses	12.9	9.8	8.2	9.1	9.4	11.2	15.0	36.1
E	Supplemental Income Schedule	18.1	17.4	16.5	13.0	14.6	16.4	19.0	40.3
F	Farm Income and Expenses	4.3	9.2	3.9	3.7	5.5	3.2	3.4	4.9
G	Income Averaging	9.2	0.6	0.6	3.5	5.1	9.4	15.5	29.7
R RP	Credit for the Elderly	1.1	-	2.7	1.4	1.0	0.6	0.9	1.1
SE	Computation of Social Security Self-Employment Tax	15.4	26.3	19.7	14.3	15.0	12.7	12.2	18.6
W	Deduction for a Married Couple When Both Work	30.8	1.6	8.0	13.0	22.2	36.3	57.1	41.8
1116	Computation of Foreign Tax Credit	0.4	-	0.2	-	0.2	0.4	0.6	1.9
2106	Employee Business Expenses	10.2	1.9	4.5	8.5	9.9	12.5	12.9	16.0
2119	Sale or Exchange of Principal Residence	1.3	0.6	1.0	1.0	1.4	1.3	1.3	3.1
2210/ 2210F	Underpayment of Estimated Income Tax	6.2	4.1	7.8	8.5	5.8	4.0	4.7	14.8
2440	Disability Income Exclusion	0.5	1.9	1.0	0.4	0.6	0.1	-	0.4
2441	Credit for Child and Dependent Care Expenses	8.5	1.3	4.9	8.7	9.6	10.5	10.9	6.9
3468	Computation of Investment Credit	6.4	5.4	4.5	6.0	7.2	4.4	6.1	17.9
3903	Moving Expense Adjustment	2.1	0.9	2.1	3.3	2.7	2.0	1.7	1.5
4136	Computation of Credit for Federal Tax on Gasoline, Special Fuels, and Lubricating Oil	1.3	3.2	1.2	1.7	1.4	0.8	0.9	1.1
4255	Recapture of Investment Credit	0.8	0.6	0.2	1.0	1.0	0.7	0.6	1.9
4562	Depreciation	14.2	18.7	13.6	11.4	15.0	12.8	13.1	23.2
4684	Casualties and Thefts	2.5	0.6	0.8	0.4	1.9	2.2	4.5	6.8
4797	Supplemental Schedule of Gains and Losses	2.2	4.4	1.0	1.0	3.5	1.7	2.1	3.1
4868	Application for Automatic Extension of Time to File	0.3	0.3	-	0.2	-	0.3	0.3	1.5
5329	Return for Individual Retirement Arrangement Taxes	0.2	-	0.2	-	0.2	-	0.3	0.4
5695	Residential Energy Credit	5.2	0.6	2.6	3.9	3.7	6.4	7.6	7.2
5884	Jobs Credit	0.1	0.6	-	0.2	0.2	-	-	0.4
6249/ 6249A	Computation of Overpaid Windfall Profit Tax	0.3	-	0.2	0.2	0.4	0.3	0.1	1.1
6251	Alternative Minimum Tax Computation	0.6	-	-	0.2	0.2	0.1	1.1	4.2
6252	Computation of Installment Sale Income	1.3	-	0.8	0.6	0.8	1.0	2.1	3.4

ATTACHMENT D

Page 4

Second, be sure you use the tax form that is right for you	There are three tax forms for individuals—short Form 1040EZ for certain single taxpayers, Form 1040A, and Form 1040. All taxpayers can use Form 1040 if they want to, but you will probably save time if you are able to use one of the shorter forms instead.
Form 1040EZ, Form 1040A, or Form 1040?	The following chart shows the kinds of filing statuses, exemptions, income, deductions, taxes, and credits that can be shown on Forms 1040EZ, 1040A, and 1040. Use it to help determine which form to use.

Form 1040EZ	**Form 1040A**	**Form 1040**	
Filing status: Single only	**Filing status:** Single, married filing joint, married filing separate, or head of household	**Filing status:** Single, married filing joint, married filing separate, head of household, or qualifying widow(er) with dependent child	
Number of exemptions: Only one personal exemption for yourself	**Number of exemptions:** All exemptions that you are entitled to claim	**Number of exemptions:** All exemptions that you are entitled to claim	
Only taxable income of less than $50,000	**Only taxable income of less than $50,000**	**All amounts of taxable income**	
Only income from: Wages, salaries, tips Interest (other than All-Savers interest) of $400 or less	**Only income from:** Wages, salaries, tips Interest (other than All-Savers interest) Dividends Unemployment compensation	**All sources of income:** Wages, salaries, tips Interest and dividends Unemployment compensation Self-employment (including farming) (Schedules C or F) Rents and royalties (Schedule E)	Pensions and annuities State and local income tax refunds (if taxable) Capital gains (Schedule D) Gain from the sale of your home (Form 2119) Alimony received All other sources
No itemized deductions You may deduct a part of some amounts you gave to charitable organizations	**No itemized deductions** You may deduct a part of some amounts you gave to charitable organizations	**All itemized deductions** (Use Schedule A): State and local income taxes Real estate taxes Sales taxes Interest expenses	Charitable contributions Medical and dental expenses Casualty and theft losses Miscellaneous deductions
No adjustments to income	**Adjustments to income for:** The deduction for a married couple when both work (Schedule 1) The deduction for payments to an IRA	**All adjustments to income:** Alimony paid Penalty for early withdrawal of savings Deduction for payments to an IRA or Keogh plan Moving expenses (Form 3903 or Form 3903F)	Employee business expenses (Form 2106) Disability income exclusion (Form 2440) Deduction for a married couple when both work (Schedule W) Other adjustments
No other taxes	**Other taxes:** Advance EIC payments	**Other taxes:** Advance EIC payments Self-employment tax (Schedule SE) Tax on an IRA (Form 5329) Alternative minimum tax (Form 6251)	Social security tax on tips not reported to your employer (Form 4137) Uncollected social security tax on tips shown on your Form W-2 All other income taxes
No tax credits	**Only tax credits for:** Partial political contributions credit Credit for child and dependent care expenses (Schedule 1) Earned income credit	**All tax credits:** Partial political contributions credit Earned income credit Credit for child and dependent care expenses (Form 2441) Investment credit (Form 3468) Jobs credit (Form 5884)	Foreign tax credit (Form 1116) Residential energy credit (Form 5695) Credit for the elderly (Schedules R & RP) All other credits

Department of the Treasury - Internal Revenue Service

1983 **Form 1040EZ Income Tax Return for Single filers with no dependents** (0)

OMB No. 1545-0675

Name & address

If you don't have a label, please print:

Please write your numbers like this. 1 2 3 4 5 6 7 8 9 0

▶

Write your name above (first, initial, last)

Present home address (number and street)

City, town, or post office, state, and ZIP code

Social security number ☐☐☐ ☐☐ ☐☐☐☐

Presidential Election Campaign Fund
Check box if you want $1 of your tax to go to this fund. ▶ ☐

Figure your tax

Dollars Cents

1 Wages, salaries, and tips. Attach your W-2 form(s). 1 ☐☐,☐☐☐.☐☐

2 Interest income of $400 or less. If more than $400, you cannot use Form 1040EZ. 2 ☐☐☐.☐☐

Attach Copy B of Form(s) W-2 here

3 Add line 1 and line 2. This is your **adjusted gross income.** 3 ☐☐,☐☐☐.☐☐

4 Allowable part of your charitable contributions. Complete the worksheet on page 19. Do not write more than $25. 4 ☐☐.☐☐

5 Subtract line 4 from line 3. 5 ☐☐,☐☐☐.☐☐

6 Amount of your personal exemption. 6 1,000.00

7 Subtract line 6 from line 5. This is your **taxable income.** 7 ☐☐,☐☐☐.☐☐

8 Enter your Federal income tax withheld. This should be shown in Box 9 of your W-2 form(s). 8 ☐☐,☐☐☐.☐☐

9 Use the tax table on pages 29-34 to find the **tax** on your taxable income on line 7. Write the amount of tax. 9 ☐☐,☐☐☐.☐☐

Refund or amount you owe

Attach tax payment here

10 If line 8 is larger than line 9, subtract line 9 from line 8. Enter the **amount of your refund.** 10 ☐,☐☐☐.☐☐

11 If line 9 is larger than line 8, subtract line 8 from line 9. Enter the **amount you owe.** Attach check or money order for the full amount, payable to "Internal Revenue Service." 11 ☐,☐☐☐.☐☐

Sign your return

I have read this return. Under penalties of perjury, I declare that to the best of my knowledge and belief, the return is true, correct, and complete.

Your signature Date

X

For IRS Use Only—Please do not write in boxes below. ☐ ☐☐☐ ☐

For Privacy Act and Paperwork Reduction Act Notice, see page 38.

Department of the Treasury—Internal Revenue Service

1983 **Form 1040A US Individual Income Tax Return** (0) OMB No. 1545-0085

Step 1
Name and address

Use the IRS mailing label. If you don't have a label, print or type:

Your first name and initial (if joint return, also give spouse's name and initial) Last name Your social security no.

Present home address (Number and street) Spouse's social security no.

City, town or post office, State, and ZIP code

Presidential Election Campaign Fund

Do you want $1 to go to this fund? ☐ Yes ☐ No

If joint return, does your spouse want $1 to go to this fund? ☐ Yes ☐ No

Step 2
Filing status
(Check only one)

1 ☐ Single (See if you can use Form 1040EZ.)

2 ☐ Married filing joint return (even if only one had income)

3 ☐ Married filing separate return. Enter spouse's social security number above and spouse's full name here. ______

4 ☐ Head of household (with qualifying person). If the qualifying person is your unmarried child but not your dependent, write this child's name here. ______

Exemptions

Always check the exemption box labeled Yourself. Check other boxes if they apply.

5a ☐ Yourself ☐ 65 or over ☐ Blind

b ☐ Spouse ☐ 65 or over ☐ Blind

Write number of boxes checked on 5a and b ______

c First names of your dependent children who lived with you ______

Write number of children listed on 5c ______

Attach Copy B of Form(s) W-2 here

d Other dependents.

1. Name	2. Relationship	3. Number of months lived in your home	4. Did dependent have income of $1,000 or more?	5. Did you provide more than one-half of dependent's support?

Write number of other dependents listed on 5d ______

e Total number of exemptions claimed

Add numbers entered on lines above ______

Step 3
Total income

6 Wages, salaries, tips, etc. (Attach Form(s) W-2.) 6 ______

7 Interest income. (If line 7 is over $400, also complete Schedule 1, Part I.) 7 ______

Attach check or money order here

8a Dividends. (If line 8a is over $400, also complete Schedule 1, Part II.) 8a ______

b Exclusion. See the instructions on page 14 8b ______

c Subtract line 8b from line 8a. Write the result. 8c ______

9a Unemployment compensation (insurance), from Form(s) 1099-G. 9a ______

b Taxable amount, if any, from the worksheet on page 15 of the instructions. 9b ______

10 Add lines 6, 7, 8c, and 9b. Write the total. This is your total income. 10 ______

Step 4
Adjusted gross income

11a IRA deduction, from the worksheet on page 17. 11a ______

b Write IRA payments made in 1984 that you included on line 11a. ($ ______)

12 Deduction for a married couple when both work. Complete Schedule 1, Part III. 12 ______

13 Add lines 11a and 12. Write the total. These are your total adjustments. 13 ______

14 Subtract line 13 from line 10. Write the result. This is your adjusted gross income 14 ______

1983

Schedule 1
(Form 1040A)

Part I—Interest Income
Part II—Dividend Income
Part III—Deduction for a Married Couple When Both Work

OMB No. [illegible]

Name(s) as shown on Form 1040A

Your social security number

Test to see when you MUST complete and attach Schedule 1 to Form 1040A

If you—	Complete the following part of Schedule 1—
• Have over $400 of interest income	• Part I. Interest income
• Have over $400 of dividend income	• Part II. Dividend income
• Claim the deduction for a working married couple	• Part III. Deduction for a married couple when both work
• Claim the credit for child and dependent care expenses	• Part IV. Credit for child and dependent care expenses

Part I **Interest income** (See page 13)

Complete this part and attach Schedule 1 to Form 1040A if you received over $400 in interest income. If you received any interest from an All-Savers Certificate (ASC), use Form 1040 instead of Form 1040A.

1 List names of payers	Amount
	$.
	$.
	$.
	$.
	$.
	$.
	$.
	$.

2 Add amounts on line 1. Write the total here and on line 7 of Form 1040A. 2

Part II **Dividend income** (See page 14)

Complete this part and attach Schedule 1 to Form 1040A if you received over $400 in dividends.

1 List names of payers	Amount
	$.
	$.
	$.
	$.
	$.
	$.
	$.
	$.

2 Add amounts on line 1. Write the total here and on line 8a of Form 1040A. 2

Part III **Deduction for a married couple when both work** (See page 18)

21

Complete this part to figure the amount you can deduct on line 12 of Form 1040A. Attach Schedule 1 to Form 1040A.

			(a) You	(b) Your spouse
1	Wages, salaries, tips, etc., from line 6 of Form 1040A.	1	.	.
2	IRA deduction, from line 11a of Form 1040A.	2 −	.	− .
3	Subtract line 2 from line 1. Write the result.	3 =	.	= .

4	Write the amount from line 3, column (a) or (b) above, whichever is smaller	4	.
5	Multiply the amount on line 4 above by 10% (.10)	5	× .10
6	Write your answer here and on line 12 of Form 1040A	6 =	

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 1983 (X)

For the year January 1–December 31, 1983, or other tax year beginning , 1983, ending , 19 OMB No. 1545-0074

Use IRS label. Otherwise, please print or type.

Your first name and initial (if joint return, also give spouse's name and initial) Last name **Your social security number**

Present home address (Number and street, including apartment number, or rural route) **Spouse's social security number**

City, town or post office, State, and ZIP code Your occupation

Spouse's occupation

Presidential Election Campaign ▶ Do you want $1 to go to this fund? ☐ Yes ☐ No

If joint return, does your spouse want $1 to go to this fund? ☐ Yes ☐ No

Note: Checking "Yes" will not increase your tax or reduce your refund.

For Privacy Act and Paperwork Reduction Act Notice, see Instructions.

Filing Status

Check only one box.

1 ☐ Single

2 ☐ Married filing joint return (even if only one had income)

3 ☐ Married filing separate return. Enter spouse's social security no. above and full name here ____________

4 ☐ Head of household (with qualifying person). (See page 6 of Instructions.) If the qualifying person is your unmarried child but not your dependent, write child's name here ____________

5 ☐ Qualifying widow(er) with dependent child (Year spouse died ▶ 19). (See page 6 of Instructions.)

Exemptions

Always check the box labeled Yourself. Check other boxes if they apply.

6a ☐ Yourself ☐ 65 or over ☐ Blind

b ☐ Spouse ☐ 65 or over ☐ Blind

Enter number of boxes checked on 6a and b ▶

c First names of your dependent children who lived with you ____________

Enter number of children listed on 6c ▶

d Other dependents (1) Name	(2) Relationship	(3) Number of months lived in your home	(4) Did dependent have income of $1,000 or more?	(5) Did you provide more than one-half of dependent's support?

Enter number of other dependents ▶

e Total number of exemptions claimed

Add numbers entered in boxes above ▶ ☐

Income

Please attach Copy B of your Forms W-2, W-2G, and W-2P here.

If you do not have a W-2, see page 5 of Instructions.

Please attach check or money order here.

7 Wages, salaries, tips, etc. | 7

8 Interest income *(also attach Schedule B if over $400 or you have any All-Savers interest)* | 8

9a Dividends *(also attach Schedule B if over $400)* ____ , 9b Exclusion ____

c Subtract line 9b from line 9a and enter the result | 9c

10 Refunds of State and local income taxes, from worksheet on page 10 of Instructions *(do not enter an amount unless you deducted those taxes in an earlier year—see page 10 of Instructions)* | 10

11 Alimony received | 11

12 Business income or (loss) *(attach Schedule C)* ▶ | 12

13 Capital gain or (loss) *(attach Schedule D)* | 13

14 40% capital gain distributions not reported on line 13 (See page 10 of Instructions) | 14

15 Supplemental gains or (losses) *(attach Form 4797)* | 15

16 Fully taxable pensions, IRA distributions, and annuities not reported on line 17 | 16

17a Other pensions and annuities, including rollovers. Total received | 17a

b Taxable amount, if any, from worksheet on page 10 of Instructions | 17b

18 Rents, royalties, partnerships, estates, trusts, etc. *(attach Schedule E)* | 18

19 Farm income or (loss) *(attach Schedule F)* ▶ | 19

20a Unemployment compensation (insurance). Total received | 20a

b Taxable amount, if any, from worksheet on page 11 of Instructions | 20b

21 Other income (state nature and source—see page 11 of Instructions) ____ | 21

22 **Total income.** Add amounts in column for lines 7 through 21 ▶ | 22

Adjustments to Income

(See Instructions on page 11)

23 Moving expense *(attach Form 3903 or 3903F)* | 23

24 Employee business expenses *(attach Form 2106)* | 24

25a IRA deduction, from the worksheet on page 12 | 25a

b Enter here IRA payments you made in 1984 that are included in line 25a above ▶

26 Payments to a Keogh *(H.R. 10)* retirement plan | 26

27 Penalty on early withdrawal of savings | 27

28 Alimony paid | 28

29 Deduction for a married couple when both work *(attach Schedule W)* | 29

30 Disability income exclusion *(attach Form 2440)* | 30

31 **Total adjustments.** Add lines 23 through 30 ▶ | 31

Adjusted Gross Income

32 **Adjusted gross income.** Subtract line 31 from line 22. *If this line is less than $10,000, see "Earned Income Credit" (line 59) on page 16 of Instructions. If you want IRS to figure your tax, see page 3 of Instructions* ▶ | 32

Form 1040 (1983) Page 2

Tax Computation (See Instructions on page 13)	33	Amount from line 32 (adjusted gross income)		33
	34a	If you itemize, complete Schedule A (Form 1040) and enter the amount from Schedule A, line 28 **Caution:** If you have unearned income and can be claimed as a dependent on your parent's return, check here ▶ ☐ and see page 13 of the Instructions. Also see page 13 of the Instructions if • You are married filing a separate return and your spouse itemizes deductions, OR • You file Form 4563, OR • You are a dual-status alien.		34a
	34b	If you do not itemize deductions on Schedule A (Form 1040), complete the worksheet on page 14. Then enter the allowable part of your charitable contributions here		34b
	35	Subtract line 34a or 34b, whichever applies, from line 33		35
	36	Multiply $1,000 by the total number of exemptions claimed on Form 1040, line 6e		36
	37	Taxable Income. Subtract line 36 from line 35		37
	38	Tax. Enter tax here and check if from ☐ Tax Table, ☐ Tax Rate Schedule X, Y, or Z, or ☐ Schedule G		38
	39	Additional Taxes. (See page 14 of Instructions.) Enter here and check if from ☐ Form 4970, ☐ Form 4972, ☐ Form 5544, or ☐ section 72 penalty taxes		39
	40	**Total.** Add lines 38 and 39 ▶		40
Credits (See Instructions on page 14)	41	Credit for the elderly *(attach Schedules R&RP)*	41	
	42	Foreign tax credit *(attach Form 1116)*	42	
	43	Investment credit *(attach Form 3468)*	43	
	44	Partial credit for political contributions	44	
	45	Credit for child and dependent care expenses *(attach Form 2441)*	45	
	46	Jobs credit *(attach Form 5884)*	46	
	47	Residential energy credit *(attach Form 5695)*	47	
	48	**Total credits.** Add lines 41 through 47		48
	49	**Balance.** Subtract line 48 from line 40 and enter difference (but not less than zero) ▶		49
Other Taxes (Including Advance EIC Payments)	50	Self-employment tax *(attach Schedule SE)*		50
	51	Alternative minimum tax *(attach Form 6251)*		51
	52	Tax from recapture of investment credit *(attach Form 4255)*		52
	53	Social security tax on tip income not reported to employer *(attach Form 4137)*		53
	54	Uncollected employee social security tax and RRTA tax on tips *(from Form W-2)*		54
	55	Tax on an IRA *(attach Form 5329)*		55
06	56	**Total tax.** Add lines 49 through 55 ▶		56
Payments Attach Forms W-2, W-2G, and W-2P to front	57	Federal income tax withheld	57	
	58	1983 estimated tax payments and amount applied from 1982 return	58	
	59	Earned income credit. If line 33 is under $10,000, see page 16	59	
	60	Amount paid with Form 4868	60	
	61	Excess social security tax and RRTA tax withheld (two or more employers)	61	
	62	Credit for Federal tax on special fuels and oils *(attach Form 4136)*	62	
	63	Regulated Investment Company credit *(attach Form 2439)*	63	
	64	**Total payments.** Add lines 57 through 63 ▶		64
Refund or Amount You Owe	65	If line 64 is larger than line 56, enter amount **OVERPAID** ▶		65
	66	Amount of line 65 to be **REFUNDED TO YOU** ▶		66
	67	Amount of line 65 to be applied to your 1984 estimated tax ▶	67	
	68	If line 56 is larger than line 64, enter **AMOUNT YOU OWE.** Attach check or money order for full amount payable to "Internal Revenue Service." Write your social security number and "1983 Form 1040" on it ▶ (Check ▶ ☐ if Form 2210 (2210F) is attached. See page 17 of Instructions.) $		68

Please Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Your signature Date ▶ Spouse's signature (if filing jointly, BOTH must sign)

Paid Preparer's Use Only	Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's social security no
	Firm's name (or yours, if self-employed) and address ▶		E.I. No.	
			ZIP code	

㉔

SCHEDULES A&B (Form 1040)
Department of the Treasury
Internal Revenue Service (0)

Schedule A—Itemized Deductions

(Schedule B is on back)
▶ Attach to Form 1040. ▶ See instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074
1983
07

Name(s) as shown on Form 1040

Your social security number

Medical and Dental Expenses **(Do not include expenses reimbursed or paid by others.)** *(See page 18 of Instructions.)*	1	Medicines and drugs	1		
	2	Write 1% of Form 1040, line 33	2		
	3	Subtract line 2 from line 1. If line 2 is more than line 1, write zero		3	
	4	Other medical and dental expenses:			
	a	Doctors, dentists, nurses, hospitals, insurance premiums you paid for medical and dental care, etc.		4a	
	b	Transportation		4b	
	c	Other (list—include hearing aids, dentures, eyeglasses, etc.) ▶		4c	
	5	Add lines 3 through 4c		5	
	6	Multiply amount on Form 1040, line 33, by 5% (.05)		6	
	7	Subtract line 6 from line 5. If line 6 is more than line 5, write zero ▶			7
Taxes *(See page 19 of Instructions.)*	8	State and local income		8	
	9	Real estate		9	
	10 a	General sales (see sales tax tables)		10a	
	b	General sales on motor vehicles		10b	
	11	Other (list—include personal property) ▶		11	
	12	Add lines 8 through 11. Write your answer here ▶			12
Interest Expense *(See page 20 of Instructions.)*	13 a	Home mortgage interest paid to financial institutions		13a	
	b	Home mortgage interest paid to individuals (show that person's name and address) ▶		13b	
	14	Credit cards and charge accounts		14	
	15	Other (list) ▶		15	
	16	Add lines 13a through 15. Write your answer here ▶			16
Contributions *(See page 20 of Instructions.)*	17 a	Cash contributions. (If you gave $3,000 or more to any one organization, report those contributions on line 17b.)		17a	
	b	Cash contributions totaling $3,000 or more to any one organization. (Show to whom you gave and how much you gave.) ▶		17b	
	18	Other than cash (attach required statement)		18	
	19	Carryover from prior year		19	
	20	Add lines 17a through 19. Write your answer here ▶			20
Casualty and Theft Losses	21	Total casualty or theft loss(es) (attach Form 4684) (see page 20 of Instructions) ▶			21
Miscellaneous Deductions *(See page 21 of Instructions.)*	22	Union and professional dues		22	
	23	Tax return preparation fee		23	
	24	Other (list) ▶		24	
	25	Add lines 22 through 24. Write your answer here ▶			25
Summary of Itemized Deductions *(See page 21 of Instructions.)*	26	Add lines 7, 12, 16, 20, 21, and 25			26
	27	If you checked Form 1040 { Filing Status box 2 or 5, write $3,400 Filing Status box 1 or 4, write $2,300 Filing Status box 3, write $1,700 }			27
	28	Subtract line 27 from line 26. Write your answer here and on Form 1040, line 34a. (If line 27 is more than line 26, see the Instructions for line 28 on page 21.) ▶			28

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule A (Form 1040) 1983

STATEMENT OF HON. JAMES M. SHANNON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. Chairman, I am pleased to have the opportunity to participate in this discussion of comprehensive tax reform. It's about the most important thing we could be discussing, because every single person in this country is in some way affected by our tax structure—and our tax structure is a mess.

There are three standards by which tax systems are commonly judged: equity, efficiency, and simplicity. Our current tax system fails miserably on all three counts. Although we achieve a measure of equity through the progressivity of our tax rates, this progressivity is seriously eroded by the many loopholes that corporations and individuals in the top brackets can use to lessen their tax liability; loopholes that are, for the most part, unavailable to the average taxpayer. Efficiency has been sacrificed to other objectives which may or may not be more worthy; as a result the Internal Revenue Code is a series of skewed incentives. To even mention simplicity and the American tax system in the same breath is laughable. And every time we pass a new tax bill, we only seem to make the whole situation worse.

I must admit to some skepticism about the prospects of successfully overhauling the entire system, although I certainly think it is important that we discuss it. But I have developed a proposal that I think would substantially improve the system. It is similar to a proposal that we took a close look at in 1981— a first year capaital cost recovery system to replace the ACRS system that we enacted back then. Under my proposal, a first year capital recovery allowance based on the present value of ecomomic depreciation would be combined with a first year investment tax credit so as to produce a constant effective tax rate of 40% on investment in each and every type of asset. In addition to providing a long-run increase in revenues, this proposal would make the tax system more neutral among different types of investment and would end the bonanza that many corporations are now reaping from ACRS. It is my belief that a switch to a system like this would be an important step in making the tax laws more equitable and efficient. I am currently having this proposal drafted into legislation, and plan to introduce it as my contribution to the ongoing dialogue on tax reform.

We're probably going to hear a lot of measures discussed in the next couple of days, and Congress may even end up enacting one or more of them next year. I would like to urge that if Congress does make changes in the tax structure, when the time comes to make the inevitable tradeoffs between the three ideals of equity, efficiency, and simplicity, you come down hard on the side of equity. I don't think that anything is more important in a country such as ours than that the tax system be fair to everyone, regardless of economic status or income bracket. It is the fairness of the system, more than anything else, that has been so terribly eroded over the past few years. It is time for Congress to start restoring it.

STATEMENT OF WALLACE D. BARLOW, EXECUTIVE DIRECTOR, SHARE THE WORK COALITION

FULL EMPLOYMENT WOULD ERADICATE THE DEFICIT

An important discovery has been made. It will enable any industrialized nation to establish firm control over the level of unemployment. This is done by reforming the corporation tax. The rates would be set inversely proportional to the labor content of the product. This makes it advantageous for employers to hire humans, rather than robots. The bigger the payroll, the lower the tax. The rates would be revised annually, in accordance with the need.[1] [2]

The Coalition also supports a bill that would do away with that relic of the Dark Ages known as the Gregorian Calendar. The people that gave you Monday Holidays in 1968, would triple the holidays, with most of the new holidays falling in the late Spring, Summer and early Fall. The work year would be cut by 6%, thereby creating 8 million job careers.

Here is the impact on the deficit: First, lets make an honest count of the unemployed. If we count the "discouraged" unemployed and one half of the involuntary part-timers, we have a total of 13,000,000. If we put them back to work, and if they produce as much as 85% of the production of the average worker in the private sector, they will earn an average of $12,730 per year. About 12% of this will accrue to the Federal government as "revenue enhancement." This amounts to $20,000,000,000. Also, and more important, the government will save about $11,000 per person, per year, that was formerly spent for "relief". This comes to $143 billion per year. The grand total is $163 billion per year, or 489 billion in a 3 year period. No more deficit!

---

[1] The effective tax rate for the "smokestack" industries is 33%. The capital-intensive industries pay only 19%. This subsidy has been paid for 65 years. Much of the present unemployment has been created by this subsidy.

[2] Our bill amends Sec. 11b of Part II of Subchapter A of Chapter 1 of the Internal Revenue Code. It defines "Labor Content" as "Wages as a % of Value Added". The term "wages" is very broadly defined. It includes all salaries, except for those of top management. It directs Treasury to prepare tables which would set the corporation tax rates inversely proportional to the labor content of the average product of the corporation, as defined by the Standard Industrial Classification. It directs Commerce to assist Treasury in updating the rates for year to year; also by determining how much "tilt" is needed.

STATEMENT OF FORTESCUE W. HOPKINS, PRESIDENT, TAXATION WITHOUT DISCRIMINATION [TWD]

I am honored to have this opportunity to present TWD's Tax Magna Carta, a proposed Constitutional Amendment which I respectfully request that your Committee approve and submit to both houses of Congress for their consideration and approval:

THE TAX MAGNA CARTA CONSTITUTIONAL AMENDMENT

In securing the revenue of the United States or of any State, district, territory or political subdivision thereof, no law, regulation or procedure with respect to any individual citizen or equity or nonequity entity or organization domociled in the United States, shall be in the slightest degree either discriminatory or intended to achieve a nonrevenue related objective; provided, however, that, with respect to any income tax: (1) Income or loss of an equity type organization (stock corporation, partnership, etc.) shall be deemed passed through to its equity holders; (2) religious organizations, estates and trusts (to the extent of income not distributable to beneficiaries), associations and nonstock, nonequity, entities of any kind shall be taxed as an individual citizen; (3) that only "net income will be taxed, which is defined as the receipt of anything of value less cost or directly related expenses in the production of value, and (4) that "directly related expenses" shall be deemed to include the value of gifts to religious organizations and all costs related to their religious activities.

ARGUMENT IN SUPPORT OF THE TAX MAGNA CARTA

History

It has been said that "those who forget history are forever condemned to repeat it". The first recorded discriminatory income tax was imposed during the Archonship of Nausinicus (Athens, B.C. 380). Other discriminatory taxes (exemptions and progressive rate taxes) were: the French *Cinquantieme* of 1295, the English graduated poll tax of 1379 and graduated income tax of 1435, the German *Reichsabchied* of 1512, the *Catasto* of Firenze (1427).

The Medici, of course, eagerly seized upon this democratic reasoning and converted the graduated tax into an engine for ruining their wealthy rivals. The history of the Florentine *Decima Scalata* (1480) has been made use of as a warning of the evils of progressive rate taxation. The list goes on and on. Very few countries have failed to impose discriminatory income taxes. In Florence and in France, the evils and abuse of discriminatory taxation ultimately led to revolution. After the Revolution in France all income taxes were abolished.

Is it to be supposed that our patriots who framed our Constitution in 1787 and 1788 were not the most educated and talented group of people ever assembled? Is it to be inferred that they were not familiar with the evils of discriminatory taxation as demonstrated by the examples of history? Is it to be supposed that the principal reasons for the American Revolution (the discriminatory taxes imposed by Great Britain-the Stamp Act, the Tea Act, Navigation Acts and other inflamatory imposts) were so quickly forgotten by the Framers?

Not so, the Framers of our Constitution thought they had forever prohibited discriminatory taxation by requiring direct taxes to be apportioned and indirect taxes to be uniform. They intended "uniform" to mean "uniform and equal" (non-discriminatory) and by failing to more precisely define their understanding of the meaning of "uniform" they failed to anticipate the "slipperiness of the eels of the law" (Jefferson's observation of the Supreme Court). They also failed to precisely define "direct" and "indirect taxes" again giving the eels of the law the opportunity to redefine "indirect taxation" to their own "Communistic" predilections. The second plank of the Communist Manifesto advocates progressive rate taxation.

Except for a brief period during the Civil War, there were no discriminatory taxes imposed by the United States until 1895. Thus for a period of over 100 years our Legislators and Courts alike, thought that "uniform" meant "uniform, equal and non-discriminatory'.

In 1895, Congress imposed a 2% flat income tax with a $4,000 exclusion and other exemptions. In its semial decision that this tax was unconstitutional the Supreme Court in *Pollock* v. *Farmers Loan & Trust Co.* (1895), came up with three important conclusions;

1. An income tax on rents and royalties was a "direct tax" and had to be apportioned.
2. A tax on income from State and Municipal obligations was unconstitutional.
3. The income tax with respect to other income was an excise (an indirect tax).
4. The $4000 exemption was a discriminating feature and violated the intent of the Framers of the Constitution to provide against discriminatory taxation and was not within the intended meaning of the term "uniform".

The reasoning of Justice Field in the Pollock case bears repeating:

"The income tax law under consideration is marked by discriminating features which affect the whole law. It discriminates between those who receive an income of $4000 and those who do not. It thus vitiates in my judgment, by this arbitrary discrimination, the whole legislation."

"Whenever a distinction is made in the burdens a law imposes or in the benefits it confers on any citizens by reason of their birth, or wealth, or religion, it is class legislation, and leads inevitably to oppression and abuses, and to general unrest and disturbance in society."

"Under wise and constitutional legislation, every citizen should contribute his proportion, however small the sum, to the support of the government, and it is no kindness to urge any of our citizens to escape from that obligation. If he contributes the smallest mite of his earnings to that purpose, he will have a greater regard for the government and more self-respect for himself, feeling that, though he is poor in fact, he is not a pauper of his government. And it is to be hoped that, whatever woes and embarrassments may betide our people, they may never lose their manliness and self-respect. Those qualities preserved, they will ultimately triumph over all reverses of fortune."

If the foregoing statement means anything, it suggests that a self assessing tax system cannot be sustained without self respect and individual political responsibility. Justice Field closed his opinion with the following:

"Here I close my opinion. I could not say less in view of questions of such gravity that go down to the very foundation of the government. If the provisions of the constitution can be set aside by an act of congress, where is the course of usurpation to end? The present assault upon capital is but the beginning. It will be but the stepping-stone to others, larger and more sweeping, till our political contests will become a war of the poor against the rich-a war constantly growing in intensity and bitterness. "If the court sanctions the power of discrimination taxation, and nullifies the uniformity mandate of the constitution" as said by one who has been all his life a student of our institutions" it will mark the hour when the sure decadence of our present government will commence." If the purely arbitrary limitation of four thousand dollars in the present law can be sustained, none having less than that amount of income being assessed or taxed for the support of the government, the limitation of future congresses may be fixed at a much larger sum, at five or ten or twenty thousand dollars, parties possessing an income of that amount alone being bound to bear the burdens of government; or the limitation may be designated at such an amount as a board of "walking delegates" may deem necessary. There is no safety in allowing the limitation to be adjusted except in strict compliance with the mandates of the constitution, which require its taxation, if imposed by direct taxes, to be apportioned among the states according to their representation, and, if imposed by indirect taxes, to be uniform in operation and, so far as practicable, in proportion to their property, equal upon all citizens."

Five years later in 1900, the Supreme Court considered a Federal Legacy (Estate) tax in the case of *Knowlton* v. *Moore* (178 U.S. 41). The Court held that the tax was laid upon the right of transmitting property from the dead to the living; and the fact that this privelege was granted by the State did not deprive the United States of the right to impose the tax. The purpose of this "fiction" was to enable the Supreme Court to classify what by any definition was a direct tax as an indirect tax and subject to rule of "uniformity throughout the United States". Apparently, it was deemed that getting around the uniformity requirement would be less difficult than obscuring the apportionment requirement of a direct tax.

Justice White, in his opinion in the *Knowlton* case held that the uniformity requirement of an indirect tax was only "geographical" in its character and did not require intrinsic uniformity (equal & nondiscriminatory).

In the *Pollock* case this contention was specifically rejected; "A law containing arbitrary exceptions can in no just sense be termed uniform".

Following the 1895 decision in *Pollock* the personnel of the Supreme Court was substantially changed by 1900. Chief Justice White (who dissented in the *Pollock* case) took the opportunity in the *Knowlton* case to convince a majority of his brethren to reverse Justice Field's views that "uniformity" meant equal and non discriminatory and, in so doing, justified it with the following rationale:

"The review which we have made exhibits the fact that taxes imposed with reference to the ability of the person upon whom the burden is placed to bear the same have been levied from the foundation of the government. so, also, some authoritative thinkers, and a number of economic writers, contend that a progressive tax is more just and equal than a proportional one. In the absence of constitutional limitation, the question whether it is or is not is legislative and not judicial. The grave consequences which it is asserted must arise in the future if the right to levy a progressive tax be recognized involves in its ultimate aspect the mere assertion that free and representative government is a failure, and that the grossest abuses of power are foreshadowed unless the courts usurp a purely legislative function. If a case should ever arise, where an arbitrary and confiscatory exaction is imposed bearing the guise of a progressive or any other form of tax, it will be time enough to consider whether the judicial power can afford a remedy by applying inherent and fundamental principles for the protection of the individual, even though there be no express authority in the Constitution to do so. That the law which we have construed affords no ground for the contention that the tax imposed is arbitrary and confiscatory is obvious."

Justice Whites assumption that a free and representative government can safely handle discriminatory taxes without the grossest abuses of power has now been tested by 84 years of experience. If this is true what then is the purpose of these Tax Reform Options Hearings? I cannot help but speculate that Justice White being from Louisiana was schooled in the Napoleonic Code and not the English common law because it is difficult to believe that any Justice schooled in the legal history of the English common law would ever have made such a statement giving to what was supposed to be a government of limited powers such unlimited power.

The reality, however, is that there is no case in history of a Free and Representative Government being given the unlimited power of discriminating taxation that did not indulge in the grossest abuses of that power. For example, the retroactive reversal of the Supreme Courts *Diedrick* decision in DRA-84 for the sole benefit of a group of wealthy people is an illustration of what I at least, consider to be the grossest possible abuse of this power.

Following in the footsteps of *Knowlton*, the Supreme Court held in *Flint* v. *Stone Tracy* (1907) that a corporate progressive rate income tax with exemptions was an indirect tax subject to the rule of geographic uniformity. No mention was made that they had, in effect, overruled their previous decision in *Pollock* that an income tax on rents & royalties was a "direct" tax.

Upon reviewing this decision Congress decided that it would like to impose an income tax. Congress was relatively certain, in view of the *Flint and Knowlton* cases that the Supreme Court would reverse its decision in *Pollock* and hold an income tax constitutional. However, it was afraid that the average American would lose respect for a Supreme Court making such a hasty flip-flop. Also, Congress wanted to reverse the *Pollock* holding that State and Municipal bonds were exempt from Federal taxes. Also, Congress wanted to remove the apportionment requirement in case any tax was held to be a direct tax. Accordingly the 16th Amendment was proposed by Congress and ratified by the States. This Amendment simply provided that Congress could levy a tax on "income from any source whatsoever without regard to apportionment".

There are some people in the United States who are under the impression that income taxes, discriminatory or otherwise are authorized by the 16th Amendment. However there is nothing in this Amendment that authorizes discriminatory income taxes. On the contrary, by permitting the taxation of tax exempts, this Amendment is totally consistent with the TAX MAGNA CARTA.

The great irony of the 16th Amendment is that Congress has chosen to continue tax exempts and that the Supreme Court in *Brushaber* v. *Union Pacific* (1916) ignored the purpose of this Amendment by relying for its justification of income taxes as an indirect tax and as a discriminatory tax on its two previous cases of *Flint and Knowlton.*

Justice White in the *Knowlton* case said that the Supreme Court had not totally opened the Pandora's Box of discriminatory taxation and that if things got out of hand they would apply "inherent and fundamental principles for the protection of the individual. In the last few years there are no cases to my knowledge wherein the Supreme Court has held a section of the Internal Revenue Code unconstitutional.

Sadly, it is evident that the Supreme Court has failed to protect the rights of taxpayers from the grossest abuses of power. By its strict definition of "discrimination" in matters affecting race, religion, sex and civil rights, it has inundated itself with litigation. It obviously realizes that the slightest restriction of Congresses' abuse of the power to enact discriminatory tax laws would create a tidal wave of litigation. By permitting a discriminatory WPT, the present Supreme Court has given Congress the signal that they will countenance the "grossest abuses of power" involving discriminatory taxes. In explaining this situation to the American people, TWD does not plan to obscure the role played by the Supreme Court. TWD will advise the American people not to waste time on Congressmen who it is presumed will not violate a Patrick Henry maxim: "Power once granted to a legislative assembly will never be voluntarily surrendered", but to concentrate their efforts on the area where the only possible hope for relief from "the grossest abuses of power" exists, i.e. the Supreme Court and State Legislatures.

Finally, the only person who is in a position to fairly determine how a tax should discriminate does not live on this planet. The christian religion does not endorse progressive rates or exemptions. It does however endorse "tithes" (a proportional donation).

What will tax magna carta [TMC] accomplish?

1. TMC will reverse the error of the Supreme Court beginning in 1900.
2. TMC will give every American a sense of self-respect knowing that he has contributed his fair share to the operation of government.
3. With this self-respect, the lack of discrimination and the one page tax return for both State and Federal taxes, a self-assessing tax system will once again become totally practical.
4. TMC will eliminate Social Security (FICA) taxes but not the benefits—the flat tax rate will have to be high enough to cover these benefits. The regressive Social Security tax constitutes one of the grossest examples of discrimination against the youth, workers, minorities and small businessmen.
5. TMC permits taxation of all religious organizations but does allow an unlimited deduction for gifts to religious organizations. It is the grossest form of discrimination to require governments to render free services to religious organizations. Religious organizations will be required to file tax returns, pay tax but they will be permitted a deduction for all expenses directly related to their religious activities.
6. TMC eliminates gift and inheritance taxes as such but does tax gifts and inheritances as income to the donee (including religious organizations).
7. To produce the present revenue, the flat rate under TMC is estimated to be not in excess of 10%. The taxable base of TMC by including gifts and inheritances, etc is greater than the GNP. There is no tax exempt income, loopholes, exemptions, credits, etc. All PACS and so called tax exempt (and strictly religious) organizations would be taxed.
8. TMC is a proposed Constitutional Amendment with lasting effect and not a statute (reversable before it goes into effect).
9. TMC does not tell Congress what it can do. It does tell the Supreme Court what Congress cannot do and it does reverse certain prior erroneous Supreme Court decisions.
10. TMC would, in effect, require a proportional income tax (a flat tax) on net income but TMC imposes on restriction on a rate.
11. TMC would eliminate all presently so call "tax expenditures" including homeowners interest. If Congress wants to subsidize homeowners and such a subsidy is not permitted by our Constitution, why should they be permitted to do "indirectly" what would be "unconstitutional" if done "directly"?
12. Under TMC there would be no exclusions, (however small), no exemptions, no credits, no non-business deductions.
13. Under TMC, the tax would be on net income but there would be no discrimination or distinctions in determing net income and no nonrevenue related objectives could be sought.
14. TMC would affect not only Federal revenues laws but all State and local revenue laws. It would make all state, local and Federal income tax laws totally parallel so that one return could cover them all.
15. TMC would tax all insurance receipts, pension or profit sharing, Social Security benefits, anything of value, less first a return of capital or investment.
16. TMC would permit no distinction between "capital gain" and "ordinary income". No income would be "tax-exempt".

17. TMC would, in effect, require a greater distribution of corporate dividends to cover taxes of shareholders and since there would be no taxes at the corporate level, the expense of excessive management compensation would not have the tax saving component it does today with the result that shareholders participation and democracy in large companies would be strengthened.

A. In its blatant abuse of its power to enact discriminatory tax laws for non-revenue related objectives Congress is tampering with the very soul of America. The American people may not yet fully appreciate the danger of deficits but their rage against the proliferation of discriminatory tax laws is here and now growing at a rate the average Congressman cannot even begin to imagine. Congress has by its ever increasing creschendo of abuses lit the fuse and when the explosion is over, the power of Congress to enact discriminatory tax laws (and to feather their own nests) may be severely curtailed. Also, they may find their rules rewritten to provide a more representative form of democracy.

B. TMC will reawaken individual political responsibility. The principal beneficiaries of TMC would be be the youth, blacks, ethnic minorities and workers. TMC would reduce their overall tax rates. It would give them what, in reality, they do not now possess: "individual economic opportunity" (IEO). They could have employees, start any business no matter how small without the present choking bureaucratic red tape and the need for a lawyer and accountant. There would be no withholding and no unemployment tax. Above all, however, they would be freed from the most vicious of all taxes, which bears most heavily upon them—the regressive Social Security tax. There would be no need, as now, to be forever locked in as "second class citizens" working for big corporations or big government.

C. If, in fact, excessive power created by excessive wealth is a social evil and not merely an excuse for the elite new class (ENC) to maintain its power and prerogatives, this can be cured, at death, by state law, not by taxes, by requiring substantial devolution among heirs, as suggested by Thomas Jefferson (i.e., forced heirship laws of Louisiana). Congress, however, has now proved to the satisfaction of the American people, that the unlimited power to enact discriminatory taxes is not the way to achieve this objective.

D. The appeal of TMC is irresistable. It can be seen and easily understood by the great mass of Americans. There is no other choice, the abyss of statism is at hand. The present tax system represents the brink of this abyss. We will see if the American people have the sense and courage of their ancestors to back off. As they begin to sense the clear danger of this abyss and start putting the blame where it belongs, not on Congress (for doing only what comes naturally—buying votes) but rather on the Supreme Court Justices (who should have a higher degree of responsibility), you may see the Justices come to their senses in time to save us from a Constitutional crisis of immense magnitude.

E. TMC holds the promise of being the most important step ever made in preserving personal liberty, promoting free enterprise and keeping our free society from becoming a totalitarian police state.

WELLS FARGO BANK,
San Francisco, CA, September 21, 1984.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
U.S. House of Representatives, Washington, DC.

DEAR MR. SALMON: We would like to take this opportunity to comment on the effects of the recently passed Deficit Reduction Act.

We are aware that one of the primary intents of the Act was to stop corporations from using corporate tax deductions as a method for providing perquisites to highly paid employees. Ours is not to debate Congress's thinking on that issue, but rather to briefly overview the practical realities of the Act and its effect on the vast majority of our employee population who are not highly paid.

Wells Fargo employs approximately 15,000 people, most of whom are clerical and make less than $30,000 per year. As a matter of company policy, we strive to provide our employees, on a non discriminatory basis, a variety of benefits which would be difficult for them to obtain without our subsidy. Among these benefits are below market rate credit products (home loans and credit cards) and Company Cafeterias.

The Deficit Reduction Act directly impacts these non discriminatory products and makes them less attractive both for the employee to participate in and for the company to maintain. To track the inputed income on each employee's cafeteria subsidy will require an enormous paperwork bureaucracy. This simply does not make good business sense. The process is not worth the effort. It's far easier to significantly reduce the subsidy, move the price to market, or close the facility. It is not our "high paid" employees who frequent these facilities but rather the vast majority who need and appreciate the subsidy.

The tax legislation has a similar effect in the area of subsidized loans. The legislation imputes an income and generates a corresponding deduction. As indicated, those who file taxes and itemize deductions will not be affected. However, our lower paid employees aren't able to itemize and thus again they are the ones who are hurt.

As Personnel Director of our Corporation, I am concerned that laws of this type create so many problems for employers that the effect of the legislation will mean the end to many of the benefits that are so needed by the vast majority of our staff.

We do not believe that this legislation, while well intended, was designed to have the adverse impact on our employee population it has. As a responsible company, we ask that attention to this detail be given and modifications be made where appropriate.

Sincerely,

STEPHEN A. ENNA,
Senior Vice President and Personnel Director.

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